Go Where You Wanna Go: Considerations for Establishing a Non-U.S. Affiliate

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Introduction

U.S. investment management firms may seek to expand their operations into non-U.S. jurisdictions for a variety of reasons. Establishing a base of operations in another country can facilitate greater access to investment opportunities and investors located in that country. In addition, having staff on the ground abroad can help the firm execute trades across various time zones. Such expansion also may be prudent in connection with the launch of a new fund or other product focused specifically on the relevant jurisdiction.

Establishing a presence in a new country entails more than simply identifying office space and signing a lease—there can be a host of complicated legal, compliance and practical issues to consider. Indeed, the scope of requirements in certain jurisdictions may represent a regulatory hornet's nest. To avoid getting stung, this article highlights some of the key considerations advisers may consider in connection with establishing non-U.S. operations.

Structuring Considerations

Establishing a new entity

A U.S. investment firm should work closely with tax and legal experts to consider the various structuring considerations associated with establishing operations in a new country. An important preliminary consideration is whether to structure the non-U.S. operations as a separately-organized affiliate or a branch office of the U.S. adviser. In many cases, it may be preferable for a firm to establish a non-U.S. affiliate instead of a branch office, as an affiliated entity may structurally shield the U.S. advisory entity from the potential liabilities associated with doing business in the foreign jurisdiction. To ensure that regulatory authorities respect the affiliate's separate existence for these purposes, the entity should take care to observe applicable corporate formalities.

Sub-advisory relationships

A separately-organized non-U.S. affiliate often will establish a sub-advisory relationship with its U.S. adviser. Such an arrangement may ensure that the non-U.S. affiliate provides advisory services solely to the U.S. adviser, which may be desirable for a variety of regulatory reasons. From a tax perspective, the agreements codifying the relationship should appropriately address the compensation of the affiliate for services it will provide to the U.S. adviser. It is recommended that the entities conduct on an arm's-length basis any transactions/arrangements between them.

Staffing the non-U.S. operations

A firm also will want to take account of potential staffing issues related to the non-U.S. affiliate. In some cases, it may be desirable to have a fully-staffed non-U.S. affiliate, complete with local portfolio managers and other investment professionals, marketing or investor relations personnel and back-office support. In other cases, a more limited employee presence in the jurisdiction may be expedient. Key factors weighing on this determination include: (i) the scope of the license required by the local regulator to engage in various marketing or investment-related activities, (ii) local employment and immigration laws and (iii) tax considerations.

Relatedly, the firm may consider whether to second to the non-U.S. affiliate any members of the U.S. team. However, the activities of such employees could create the presumption that the U.S. arm is itself conducting business in the non-U.S. country. This presumption could have adverse tax consequences, such as subjecting the U.S. entity and its operations to additional taxation in the non-U.S. jurisdiction. Some firms seek to mitigate these risks by providing for reimbursement by the non-U.S. affiliate in respect of all or certain services of the seconded employees.

General Compliance Program Considerations

Appointing local compliance officers

Depending on the scope of the

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activities in the non-U.S. affiliate, a key consideration will be how to satisfy the firm's newly-expanded global compliance obligations. One of the primary decision points is whether the firm's Chief Compliance Officer ("CCO") will directly supervise compliance in the non-U.S. jurisdictions or whether the firm will hire or appoint local compliance officers to satisfy applicable local obligations. Factors relevant to this decision include whether the investment-related rules and regulations of the local jurisdiction require the presence of a local compliance officer and whether the affiliate has sufficient presence in the region to merit a dedicated local compliance professional.

As a practical matter, having the firm's CCO handle all compliance-related tasks for the non-U.S. affiliate may not be the most effective way to ensure buy-in from personnel resident in that country. Designating a local compliance officer under the supervision of the CCO—even one that functions on a part-time basis—can ensure that personnel of the non-U.S. affiliate feel connected to the larger organization from a compliance perspective. A local compliance officer also can focus on the specific requirements in the local jurisdiction, allowing the CCO to direct the firm's overall compliance program. Even if the firm appoints local compliance officers, the CCO still must have an awareness of local requirements—if for no other reason than to assess the interplay of the firm's various compliance obligations across the globe.

Gap analysis and harmonizing policies and procedures

Before it commences operations, the non-U.S. affiliate must assess whether it will be subject to local licensing or other securities or compliance requirements or whether any exemptions apply in respect of particular activities or services. This will depend, in large part, on (i) the types of products and services it will offer, (ii) the types and locations of the clients that the non-U.S. affiliate will serve and (iii) how the products and services will be marketed and sold to clients. If the non-U.S. affiliate will offer products and services in more than one jurisdiction, it will need to conduct this analysis in all relevant locations. It is important to conduct this assessment fairly early in the decision-making process. The licensing requirements in a number of jurisdictions (including the United Kingdom, Singapore and Hong Kong) can be quite burdensome and time consuming with authorization requiring lead time of up to and in excess of six months. Further, such authorization may entail onerous competency requirements relating to minimum capitalization, local examinations, local custodians and senior staff presence.

After the regulatory assessment is complete, a firm operating in both U.S. and non-U.S. jurisdictions should, to the extent practicable, consider creating a harmonized set of compliance policies and procedures. This approach can foster a consistency of approach with respect to various compliance matters and help avoid potential confusion related to subjecting personnel in various regions to differing standards. In line with this approach, the firm may need to perform a gap analysis to determine where standards differ across jurisdictions. A potential rule of thumb to consider: where the firm identifies differences, the global compliance policies generally should subject all personnel to the most stringent of the various standards. However, certain countries may have particularized rules and regulations (*e.g.*, rules related to personal securities trading) or cultural practices that present unique compliance risks, which may be best addressed with supplements to the global policies or separate local policies to address specific items.

Advisers Act Registration Considerations

If the non-U.S. affiliate provides investment advice, it must consider whether it should register or be licensed under the laws of the jurisdiction in which it is organized. A non-U.S. affiliate also should assess whether it intends to make sufficient use of U.S. jurisdictional means to trigger a possible registration under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), or under state securities laws. For example, if the non-U.S. affiliate opens a branch office in the United States to conduct advisory activities and has more than $100 million in assets under management, it likely would need to register under the Advisers Act or find an exemption or exclusion therefrom.

Foreign Private Advisers

Section 203(a)(3) of the Advisers Act contains an exemption from Advisers Act registration for certain non-U.S. advisers that have no place of business in the United States and do not hold themselves out generally to the public in the United States as advisers. In order to fit within the exemption, among other things, the non-U.S. affiliate must have, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser.[1] The non-U.S. affiliate also must have aggregate assets under management attributable to clients and investors in the United States of less than $25 million. Although this exemption can be challenging to satisfy given the low thresholds, non-U.S. affiliates that fit within it need not make any filings with the Securities and Exchange Commission ("SEC").

Private Fund Advisers

A non-U.S. affiliate also may be considered an "exempt reporting adviser" under Section 203(m) of the Advisers Act if it manages solely private funds and has less than $150 million in assets under management in the United States. A non-U.S. adviser may exclude all non-U.S. clients from this consideration and only is required to count assets managed from a place of business

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in the United States. The non-U.S. adviser's clients that are U.S. persons all must satisfy the exemption. Depending on the facts and circumstances, the SEC staff may consider multiple separately formed but affiliated advisers, each with less than $150 million in assets under management, as a single adviser for purposes of the exemption. Given the higher threshold, a number of non-U.S. advisers rely on this exemptive relief.

Private fund advisers are considered "exempt reporting advisers" and must furnish to the SEC a Form ADV containing a subset of the information required of registered advisers, including information on the exempt reporting adviser's disciplinary history, financial industry affiliations and control structure. This information must be amended and updated within the same timeframes and under the same circumstances as if it were filed by a federally-registered adviser. Notwithstanding these requirements, they are otherwise exempt from the substantive provisions of the Advisers Act.[2]

Unibanco

It is possible that the non-U.S. affiliate could rely on the Unibanco line of no-action letters as a basis for not registering under the Advisers Act.[3] In these no-action letters, the SEC staff has agreed that it would not recommend enforcement action if an unregistered foreign affiliate of a U.S. registered adviser provides services to U.S. clients through the U.S. registered adviser and shares employment and other resources, as long as certain conditions are satisfied:

- the U.S. registered adviser and the non-U.S. affiliate must be separately organized;
- the employees of the U.S. registered adviser must be capable of providing investment advice;
- the non-U.S. affiliate must, among other things, make available to the SEC staff on request all books and records relating to investment advisory services and access to its investment personnel; and
- the U.S. registered adviser must treat each employee of the non-U.S. affiliate who has access to any information concerning the securities being referred to clients as an "associated person" under the Advisers Act.

Advisers Act Registration

If a non-U.S. affiliate has sufficient contacts with the United States and an exemption is not otherwise available, it must register under the Advisers Act. It bears noting, however, that the SEC does not apply many of the substantive provisions of the Advisers Act (*e.g.*, the custody rule, the cash solicitation rule, the brochure delivery requirement, etc.) to the non-U.S. clients of a registered non-U.S. adviser. If the non-U.S. affiliate conducts a single advisory business with one or more U.S. registered advisers and if they are under common control, or one controls the other, the non-U.S. affiliate may be added to the registered adviser's existing Form ADV. To fit under the U.S. registered adviser's Form ADV "umbrella," the non-U.S. affiliate only must provide investment advice to private funds and separate account clients that are qualified clients and are otherwise eligible to invest in the private funds advised by the non-U.S. affiliate. The separate accounts must have investment strategies that are substantially similar or otherwise related to the private funds advised by the non-U.S. affiliate. Additionally, the non-U.S. affiliate, its employees and the persons acting on its behalf must be "associated persons" of the U.S. adviser and, therefore, subject to its supervision and control. The U.S. adviser and the non-U.S. affiliate must have a single code of ethics and a single set of written policies and procedures administered by a single CCO. Finally, the U.S. registered adviser must have its principal place of business and office in the United States, and the advisory activities of the foreign affiliate must be subject to the Advisers Act and SEC staff examination. The addition of a non-U.S. affiliate to an already-filed Form ADV may streamline the filing process and create efficiencies in connection with completing annual updates to the form.

Other Considerations

An exhaustive list of all potential considerations is beyond the scope of this article. However, below are certain of the other key matters that are likely to merit significant care and attention.

AML-KYC

A potential consequence of expanding operations into additional countries is the possibility of subjecting the firm to additional anti-money laundering/know your customer ("AML-KYC") rules and regulations, an increasing area of focus among global regulators. As such, it is important to understand the scope of local requirements and whether they apply to the non-U.S. affiliate's activities. In some jurisdictions (particularly in the European Economic Area), these requirements can be complicated and subject to continual evolution. By failing to keep pace with these global requirements, a firm runs the risk of exposing itself to significant penalties, as well as potential reputational costs.

FATCA

The Foreign Account Tax Compliance Act ("FATCA") contains many parallels to AML-KYC regulations. FATCA is intended to detect, prevent and deter tax evasion by U.S. persons investing through offshore accounts and vehicles. Among other things, these tax regulations compel certain non-U.S. entities to identify and report information regarding their U.S. owners—with significant penalties for non-compliance. In addition, the U.S. has executed a number of intergovernmental agreements with non-U.S. governments to help facilitate FATCA compliance with respect to taxpayers resident or conducting business in those non-U.S. jurisdictions. In

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establishing a non-U.S. affiliate, a firm likely should work with its tax professionals to determine how to classify the new entity for purposes of FATCA and applicable intergovernmental agreements and what resulting obligations will apply.

Anti-Corruption

The Foreign Corrupt Practices Act (the "FCPA") prohibits bribery of foreign government officials, candidates for political office, and political party officials. The anti-bribery provisions of the FCPA cover not only funds paid to foreign government officials, but anything of value such as gifts, entertainment, and travel. Offering financial or non-monetary benefits also may create compliance concerns under the U.K. Anti-Bribery Act of 2010. Prior to establishing a non-U.S. affiliate, a firm must take care to establish policies and procedures that: (i) impose strict gift, entertainment, and political contribution limitations and (ii) conduct and document thorough due diligence of portfolio investments to ensure the advisory group's business activities do not expose the non-U.S. affiliate or the U.S. registered adviser to anti-corruption violations.

Remuneration Requirements

Following the 2008 financial crisis, financial services regulators in a number of jurisdictions have taken a hard look at remuneration practices in the industry. As a result, certain current and proposed regulations—such as the Alternative Investment Fund Managers Directive and the Capital Requirements Directive IV—contain prescriptive measures regarding the composition of the remuneration paid to certain personnel. A firm should consider the extent to which such requirements impact the local executive or other staff performing investment activities in respect of the non-U.S. affiliate.

Conclusion

Before establishing an affiliate in a new jurisdiction, a firm should carefully assess the legal and compliance issues associated with a new corporate presence. Not every non-U.S. affiliate will present insurmountable risks; however, addressing the items described in this article at an early stage in the process can help ensure the effectiveness of the firm's global compliance program.

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[1] A "private fund" relies on the exemption set forth in either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended.

[2] Note, however, that the SEC has the authority to examine the books and records of exempt reporting advisers.

[3] Uniao de Bancos de Brasileiros S.A. (available July 28, 1992) ("Unibanco"); see also Mercury Asset Management pls (available April 16, 1993); Kleinwort Benson Investment Management Limited (available December 15, 1993); Murray Johnstone Holdings Limited (available October 7, 1994); ABN AMRO Bank N.V. (available July 1, 1997); Royal Bank of Canada (available June 3, 1998).

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Cybersecurity Resources

Cybersecurity resources can now be found in the Resource Library by selecting the newly renamed topic "Cybersecurity & Privacy." Here members can also find materials on privacy, safeguarding customer information, and identify theft red flags rules.

These materials are available on the IAA website under **Resources >> Legal/Regulatory Library >> Cybersecurity & Privacy**.