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Investment Funds 2025

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Global Practice Guides

Investment Funds

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2025

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Published by
Chambers and Partners
165 Fleet Street
London
EC4A 2AE
Tel +44 20 7606 8844
Fax +44 20 7831 5662
Web www.chambers.com

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INTRODUCTION

Contributed by: Sam Kay, **Dechert LLP**

Dechert LLP is a global law firm with 17 locations across the US, Europe, the Middle East and Asia. It has one of the largest investment fund practices in the world, with a record of innovation stretching back 40 years. It advises across the full range of mainstream and alternative asset classes and strategies, representing some of the world's largest fund complexes. The asset management practice has dedicated lawyers across 15 offices and operates as a single practice group across the globe, with no internal barriers to collaboration. Clients look to the team for support across the entire fund lifecycle, from development and formation to marketing, operations and transactions. It provides advice related to fund management and governance, and assists with the full range of regulatory and compliance issues, as well as investigations and litigation involving regulatory entities around the world.

Contributing Editor

Sam Kay is a partner in Dechert's financial services group. He advises on a wide range of investment funds matters, with a particular focus on fund formation, representing private funds and asset managers throughout the private equity, private debt/credit, infrastructure and real estate industries. Sam advises GPs on complex transactions such as continuation funds, tender offers and strip sales, and has extensive experience in advising clients on matters of strategic significance, such as GP-stake sales, internal restructurings for succession planning, management spin-outs and complex carried interest arrangements. He also advises institutional investors, funds-of-funds and asset allocators on their participation in funds, as well as LP-led secondary activity from single assets to large portfolio sales.

Dechert LLP

25 Cannon Street
London
EC4M 5UB
UK

Tel: +44 207 184 7000
Fax: +44 207 184 7001
Email: sam.kay@dechert.com
Web: www.dechert.com

Dechert
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INTRODUCTION

Contributed by: Sam Kay, **Dechert LLP**

Investment Funds 2025 – Global Overview

This cross-border legal guide provides a global comparison of fundamental legal, tax and regulatory considerations relating to the establishment and operation of investment funds in a range of jurisdictions where the industry is active. Each chapter is written by leading legal advisers from the relevant jurisdiction. Certain chapters focus on particular jurisdictions, in a question-and-answer format, providing information on the structures typically used, the regulatory framework for those funds, any significant operational requirements, how the funds may be marketed, a summary of the tax treatment for both the fund itself and investors, and customary or common terms. The guide also contains a number of chapters highlighting trends and developments in the investment funds market.

This guide seeks to provide guidance on the key questions arising when industry participants are seeking to establish, operate, market and/or invest in an investment fund. Investment funds often operate across multiple jurisdictions, so those who understand the global landscape will be at a distinct commercial advantage, and will be able to minimise their risk of falling foul of local laws.

The key objectives when setting up an investment fund that are discussed in this guide include the following.

Choice of domicile

There are a multitude of different legal structures available, and each jurisdiction applies its own legal and regulatory framework. Certain jurisdictions are traditionally utilised for certain strategies. However, ongoing legal developments in those jurisdictions, coupled with attractive investment funds regimes being introduced and/or modernised in the less obvious choices of jurisdictions seeking to compete with more established jurisdictions, mean that the domicile used by a manager for its last fund may not be the best option for its next fund. This guide will provide up-to-date information on the typical forms of investment fund vehicles available in each jurisdiction, to assist in making decisions relating to domicile.

Asset class

There is also a wide variety of asset classes that are captured within the market, from traditional long-only equity funds through to leveraged buyout funds and hedge funds. Funds for different asset classes will have their own bespoke features and requirements. The industry develops in response to demand and now offers many ways for investors to customise their exposure to certain asset classes. Current trends – such as secondaries transactions, general partner-led fund restructurings, hybrid or “evergreen” funds and the drive towards the “democratisation” of the private funds market – demonstrate that the investment funds industry is flexible and accommodating to investors.

Regulatory and tax considerations

The global investment funds industry continues to grow and innovate at pace against the backdrop of an increasingly complex regulatory, tax and legal landscape, and this is expected to carry on during 2025 and beyond. Without doubt, the number of legal, tax and regulatory issues that have to be considered when establishing an investment fund has increased significantly, and regulators and tax authorities across the world are introducing more complex reforms. A fund manager's failure to comply with these requirements can lead to significant fines or, in extreme cases, custodial sentences. Therefore, it is important to understand the applicable requirements in jurisdictions where the fund or manager is doing business.

Investor base

Another key objective when structuring an investment fund is ensuring that the fund is suitable for its proposed investors, whether that will be institutional investors or retail investors, or a combination of both. The investment funds industry is a global market, so funds will often be marketed to investors in multiple jurisdictions. Therefore, a fund needs to be flexible enough to be adapted to different groups of investors; it needs to be capable of being marketed in different jurisdictions; and it needs to be sufficiently familiar to investors. The manager and sponsor will, therefore, need to consider and take advice on the securities and marketing laws and regulations in the fund's target jurisdictions.

In many jurisdictions, the marketing or distribution of an investment fund is restricted to certain categories of investor – eg, “professional” or “sophisticated” investors (ie, not to the public at large). Funds that are targeted at retail investors are, on the whole, subject to a higher level of regulatory scrutiny and operating restrictions.

In recent years, lawmakers and regulators have continued to focus on investor protection whilst increasingly looking to ensure that the industry complies with wider ESG-related responsibilities, leading to many new (and often onerous) legal, tax and regulatory requirements. A further challenge is the need to navigate between the approaches taken in different regions or jurisdictions – eg, operating in line with EU ESG regulation – whilst also taking account of the differing views and approaches to ESG in the United States.

About this guide

To provide a framework for each jurisdiction-specific chapter, the guide focuses on two categorisations of investment funds: “alternative investment funds” and “retail funds”. There will obviously be overlaps between these two categories, and some strategies or structures will not be adequately catered for (an obvious example being listed funds aimed at institutional investors). However, the suggested split is intended to be as follows.

- Alternative investment funds cover the non-traditional private fund strategies such as private equity, venture capital, infrastructure, alternative credit, hedge funds and real estate.
- Retail funds cover the traditional mutual, authorised, regulated or registered funds that are commonly available to the public and, therefore, are not usually offered on a private placement basis. For this reason, retail funds have historically been more heavily regulated than other types of funds.

This guide not only sets out the information needed, but also provides a network of leading experts from law firms around the world who can be called upon to provide advice. The chapters in this guide have been written by some of the leading legal investment funds practitioners around the world: we thank each of them for contributing their invaluable and highly relevant industry comments.

AUSTRALIA

Australia
Sydney
Tasmania

Law and Practice

Contributed by:
Michael Lawson, Nicole Brown, Lizzie White and Tamaryn Leach
MinterEllison

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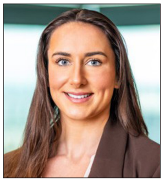
Contributed by: Michael Lawson, Nicole Brown, Lizzie White and Tamaryn Leach, **MinterEllison**

MinterEllison is a law firm operating across mainland Australia, New Zealand, Hong Kong, China, and the UK through a network of integrated and affiliated offices. MinterEllison's global reach is bolstered by a network of international offices and deep, longstanding relationships with leading independent law firms around the world. The firm is recognised as having one of the largest and most specialised financial services practices in Australia. The funds team comprises over 40 qualified practitioners with a strong understanding of the financial services regulatory environment and active participation in industry working groups. Their expertise includes fund formation, fundraising, regulatory compliance, third-party engagement, investment advice, investor negotiations, and project management. MinterEllison has advised clients such as Next Capital, Quadrant Private Equity, and Metrics Credit Partners on innovative fundraising methods. The team also collaborates with major firms like BlackRock, Vanguard, and Macquarie on investment management, particularly in exchange-traded funds and A-REITs.

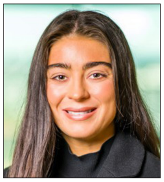
Authors

Michael Lawson is a partner and leads MinterEllison's financial services and funds group. He has advised Australian and global fund managers on all aspects of funds management and financial services for over 20 years. He has broad industry experience across domestic and international financial products, including retail and institutional funds, A-REITs, ETFs, structured products, private equity funds, hedge funds and infrastructure funds. Michael's expertise spans the development, formation and promotion of listed and unlisted investment funds, restructures of existing products, counterparty arrangements and regulatory issues. Before joining MinterEllison, Michael was part of the magic circle of Clifford Chance's market-leading funds management team in London.

Nicole Brown is a partner in MinterEllison's financial services and funds group. Nicole specialises in funds management and financial services. She has experience in advising fund managers, investment managers, responsible entities, trustees and other financial services entities in relation to a variety of financial services and funds management issues, including establishing, structuring, promoting and marketing funds. Nicole's experience covers a range of products, including retail funds, wholesale funds, exchange-traded funds and hedge funds. Her experience also includes several years with Baker McKenzie in London in its financial services team.



Lizzie White is a lawyer in MinterEllison's financial services and funds group. Having transitioned from a graduate role at the firm, she has experience in a broad range of practice areas, including financial services licensing, consumer protections, payment systems, consumer credit, product disclosure, prudential standards and privacy. She has assisted in providing advice to various entities, including financial institutions, insurers, fund managers and payment service providers.



Tamaryn Leach is a lawyer in MinterEllison's financial services and funds group. She has a broad range of experience in the financial services industry, including in financial services and credit licensing, consumer protections such as unfair contract terms, payment systems and regulations, consumer credit, anti-money laundering and counter-terrorism financing, sanctions, product disclosure, prudential standards, design and distribution obligations, scams, cybersecurity and privacy. She has been involved in due diligence projects from a regulatory perspective and in providing advice to various financial services entities, including banks, insurers, fund managers and payment service providers.

MinterEllison

Level 40, Governor Macquarie Tower
1 Farrer Place
Sydney 2000
Australia

Tel: +61 299 218 888
Fax: +61 299 218 123
Web: www.minterellison.com

MinterEllison.

1. Market Overview

1.1 State of the Market

The Australian investment funds market is highly developed from both a regulatory and commercial perspective. Australia is a jurisdiction that is welcoming to retail and alternative fund strategies and managers.

There has continued to be a significant flow of transactional and regulatory matters following initially restrained activity during the COVID-19 pandemic, and this is anticipated to continue in the year ahead.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

The most commonly used structure is a unit trust due to its flexibility.

For private equity and venture capital funds, a unit trust or a limited partnership, usually in the form of a venture capital limited partnership (VCLP) or early-stage venture capital limited partnership (ESVCLP) (in certain circumstances), can be used.

A unit trust is simpler to establish and offers greater flexibility with respect to the asset classes in which it can invest; however, certain limited partnerships can attract tax benefits for investors and fund managers when certain requirements are met.

A unit trust is a suitable local structure for hedge and credit strategies.

Following legislative changes in 2022, it is possible to establish corporate collective investment vehicles (CCIVs), which can be used as investment vehicles for a variety of asset classes.

2.1.2 Common Process for Setting Up Investment Funds

A regulated Australian unit trust will require registration with the Australian Securities & Investments Commission (ASIC). Such unit trusts are known as registered managed investment schemes. Once ASIC receives an application, it must make a decision on registration within 14 days, and the key approval criteria are:

- the trustee of the fund holds an Australian Financial Services Licence (AFSL) authorising it to be a “responsible entity” of a registered managed investment scheme;
- the responsible entity is an Australian public company; and
- the constitution of the fund meets the requirements of the Corporations Act 2001 (Cth) (the “Corporations Act”) and relevant ASIC guidance.

The key required documentation is a constitution/trust deed. An investment management agreement is also typically required, by which the trustee outsources investment management to a manager entity.

The setting-up process is not lengthy, and costs are reasonable. Establishment of a registered managed investment scheme and registration with ASIC can take place within three to four weeks.

An unregistered unit trust can be established within one to two weeks.

The above timings assume a simple structure and that relevant licensing arrangements are previously in place.

VCLPs and ESVCLPs are incorporated limited partnerships established under state-based legislation. They are bodies corporate and need to be registered with relevant state regulatory bodies. In addition, these entities require registration with Innovation and Science Australia under the Venture Capital Act 2002 (Cth) (the "VC Act"). Due to legislative requirements, the general partner of the VCLPs and ESVCLPs will generally be an incorporated limited partnership (VCMP). The general partner of that VCMP is generally a company.

The benefit of registering VCLPs and ESVCLPs is primarily the manner in which investment proceeds are taxed for both the general partner and the limited partners. Managers of each of these vehicles are required to:

- hold an AFSL;
- be an authorised representative of an AFSL holder; or
- have the benefit of a relevant exemption.
- Key documents for partnerships are:
- a partnership deed;
- a subscription agreement;
- a management agreement; and
- any side letters.

A partnership deed for the VCMP is also required.

Incorporation of a limited partnership can occur in approximately two business days with modest registration fees. A VCLP or ESVCLP registration can be conditional or unconditional, depending on whether all registration conditions have been met. Following receipt of a complete application, Innovation and Science Australia must typically make a decision regarding registration under the VC Act within 60 days, though there is a power to extend this timeframe.

A significant workstream to be undertaken on fund inception is the relevant "carry" vehicles and rules applicable for the carry participants.

As discussed later (see **2.2.2 Legal Structures Used by Fund Managers**), if a CCIV is the preferred vehicle, these are formed on registration with ASIC.

2.1.3 Limited Liability

The trust deed for most unit trusts includes what is, in effect, a contractual limitation of liability of investors. The effectiveness of such limitations has broad commercial acceptance. Despite such acceptance, the question of the legal effectiveness of such limitations has not been settled across Australia's states and territories.

In relation to limited partnership structures, as a general rule, an investor's liability is limited to the capital that they committed to the investment vehicle. Typically, if there is a tax impost relating to an investor's commitment, the investor must fund that impost.

2.1.4 Disclosure Requirements

A fundamental disclosure requirement is that communications to investors cannot be misleading or deceptive, including by omission.

Where retail investors are issued with interests in a fund, the product disclosure statement (PDS) must comply with statutory disclosure rules, including detailed cost disclosure. The issuer of the product has continuous disclosure obligations.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Institutional investors from Australia and offshore frequently invest in alternative funds. Most major Australian institutional investors have an allocation for private equity and private debt funds. Venture capital investment in Australia is primarily high net worth and/or family office-led, though some institutions have a venture capital allocation.

2.2.2 Legal Structures Used by Fund Managers

Unit Trusts

In Australia, unit trusts can be structured as open- or closed-end vehicles. Performance fees can be based on a traditional performance fee tied to net asset value increases or follow a private equity-style "carry waterfall".

There are very few legal requirements that apply to Australian unit trusts, which are simple to establish and, provided they are only offered to wholesale investors, often have no regulatory or other registration or approval requirements (note that there would typically be regulatory requirements for the manager or trustee; see **2.3 Regulatory Environment**).

A unit trust is managed by its trustee, who may, in practice, appoint an investment manager to provide investment management services in respect of the trust. The use of corporate trustees is common by fund managers who do not wish to manage the day-to-day administration of their own trust or who may lack the necessary regulatory licence to act as a trustee.

Partnerships

The common partnership structures used by a private equity or venture capital fund to invest primarily in Australian businesses are known as VCLPs for private equity and venture capital funds or ESVCLPs for early-stage venture capital funds.

Overview of VCLPs and ESVCLPs

An incorporated limited partnership must meet specific requirements before it can be registered as a VCLP or an ESVCLP with Industry Innovation and Science Australia, an Australian government department. There are specific requirements for a VCLP and an ESVCLP set out in the VC Act, with many consistencies between the two, including the following:

- the term of the partnership must be more than five years and less than 15 years;
- the minimum committed capital must be at least AUD10 million;
- the partnership must only carry on activities that are related to making eligible venture capital investments (EVCIs), as defined by relevant Australian tax legislation;
- regarding ESVCLPs, the investments must be in the "early stage".

An EVCI is an equity investment in an unlisted company or unlisted trust that:

- is located in Australia;
- does not exceed more than 30% of the partnership's committed capital; and
- has a predominant activity that is not an ineligible activity.

An ineligible activity includes:

- property development or land ownership;
- banking;
- providing capital to others;
- leasing;
- factoring;
- securitisation;
- insurance;
- construction or acquisition of infrastructure facilities and/or related facilities; and

- making investments that are directed at deriving income in the nature of interest, rent, dividends, royalties or lease payments.

For an investment to qualify as an EVCI, the investment must not exceed the value restriction imposed at the time of the investment (ie, AUD50 million for an investment by an ESVCLP and AUD250 million for an investment by a VCLP).

In addition to the requirements for registration, the VC Act applies various restrictions to these structures:

- no single investor in an ESVCLP, other than in certain circumstances, can contribute more than 30% of the total committed capital;
- the maximum committed capital for an ESVCLP is AUD200 million;
- VCLPs and ESVCLPs cannot invest in a single investment whose total assets exceed AUD200 million at the time of investment; and
- in general, they cannot make debt investments other than permitted loans as defined in the VC Act.

Given the strict requirements and restrictions imposed on VCLPs and ESVCLPs, many fund managers establish these vehicles with parallel funds (usually soft stapled-unit trusts). This structure allows fund managers to obtain the tax benefits afforded to VCLPs and ESVCLPs with respect to investments that are EVCIs while providing the fund manager with the flexibility to invest in non-EVCIs via parallel funds – a common strategy for leading Australian private equity and venture capital funds.

CCIVs

Amendments to the Corporations Act in 2022 have facilitated the emergence of a new fund vehicle – the CCIV. This vehicle is a company limited by shares, which must consist of one or more “sub-funds”. While the CCIV itself is a legal entity, sub-funds are not separate legal entities. Each share in a CCIV must be referable to a single sub-fund, and the assets of the CCIV must be allocated to a particular sub-fund in an allocation register. The Corporations Act provides that the assets of one sub-fund are not available to satisfy the liabilities of another sub-fund.

CCIVs can be structured as open-ended or closed-ended and are suitable for retail or wholesale clients. A retail CCIV is subject to specific rules broadly similar to registered managed investment schemes. A CCIV must be designated as retail or wholesale, though under certain circumstances, a CCIV will be required to register as a retail CCIV.

A CCIV is managed by a “corporate director”, which must be a public company with an AFSL authorisation to “operate the business and conduct the affairs of a CCIV” for retail or wholesale CCIVs (as applicable) holding the relevant type of assets. A CCIV and each sub-fund are established upon registration with ASIC and are governed by that CCIV’s constitution.

2.2.3 Restrictions on Investors

Australia has a highly developed and continually evolving regulatory regime in relation to investments from offshore into Australia.

In summary, the Treasurer of Australia, acting through the Foreign Investments Review Board (FIRB), can block foreign direct investment that is “contrary to Australia’s national interest” if clearance is required.

The foreign investment review framework is set by the Foreign Acquisitions and Takeovers Act 1975 (the “FATA Act”) and the Foreign Acquisitions and Takeovers Fees Impositions Act 2015, along with their associated regulations.

The legislation generally regulates foreign investment proposals by a "foreign person". Foreign persons involved in applicable transactions are required to notify FIRB. "Foreign persons" essentially means individuals, offshore companies, or onshore companies in which offshore foreigners hold a substantial interest. It includes private foreign investors and foreign government investors.

Changes to the rules applied by FIRB from 1 January 2021 also give the Treasurer "call-in powers" and "last-resort powers", by which the Treasurer may "call in" investments not notified to FIRB for review and in exceptional circumstances may exercise "last-resort powers" to impose conditions, vary existing conditions or require divestment of approved investments where national security risks emerge. In addition, a new set of rules applies for screening national security businesses, which include:

- communications (including telecommunications, broadcasting and domain name systems);
- higher education and research;
- data storage and processing;
- the defence industry;
- energy (including electricity, gas, energy market operators and liquid fuels);
- food and grocery;
- financial services and markets (including banking, superannuation, insurance and financial market infrastructure);
- healthcare and medical (including hospitals);
- space technology;
- transport (including ports, freight infrastructure, freight services, public transport and aviation); and
- water and sewerage.

The critical infrastructure rules and FIRB's guidance also outline some specific entities (eg, Australia's big supermarkets, banks, insurers and superannuation funds) as critical infrastructure assets.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Entities managing alternative funds should:

- hold an AFSL with appropriate authorisations;
- be appointed as the authorised representative of the holder of an AFSL; or
- fall within a relevant licensing exemption under the Corporations Act.

Where the fund is a unit trust, the trustee and the manager should have the appropriate authorisations regarding managing and issuing interests in a managed investment scheme. Where a foreign manager wishes to offer interests in an Australian fund, it is common to appoint a corporate trustee as the trustee of the fund, who would appoint the manager as the investment manager of the fund (see **2.3.3 Local Regulatory Requirements for Non-local Managers** regarding the regulation of the manager).

From a regulatory perspective, alternative funds open to only wholesale clients operate relatively freely.

There are very few limitations that apply to alternative funds. Significantly, for private equity funds, there are adverse tax implications if a trust were to control a business such that it would be designated a "trading trust". In such a case, the trust would potentially not be eligible to qualify as a managed investment trust and could be treated like a company (where the trust is widely held). The concept of "control" is widely interpreted for Australian income tax purposes.

In certain circumstances, including where a foreign entity holds 20% of the interests in an Australian fund or 40% of the interests in aggregate in an Australian fund are held by foreign entities and their associates, approval may be required by FIRB in respect of such fund investments.

2.3.2 Requirements for Non-Local Service Providers

Please see **2.3.3 Local Regulatory Requirements for Non-local Managers**.

2.3.3 Local Regulatory Requirements for Non-Local Managers

Non-local providers of financial services, including investment managers, have two main options for providing financial services to Australian wholesale clients in addition to the option of holding an AFSL:

- they may apply for individual relief from ASIC to be relieved of the obligation to hold an AFSL (as part of ASIC's current transitional arrangements for foreign financial services providers (FFSPs); or
- they may rely on another relevant exemption from the requirement to hold an AFSL.

The FFSP regime of exemptions is currently under review and in a period of transition. A new regime was initially proposed to take full effect on 1 April 2022 but has been delayed until 1 April 2025. The Australian federal government (the "federal government") consulted on a new direction for the regime in 2021 and introduced a bill in February 2022 – albeit, when the federal government called an election in May 2022, a bill containing proposed new exemptions lapsed. A subsequent bill containing the proposed amendments to the FFSP regime was introduced to Parliament in November 2023 with a proposed commencement date of 1 April 2025. However, as Parliament is not scheduled to reconvene until early in 2025, there remains uncertainty as to the timing of the passage of this bill.

As a result, the current licensing and exemption arrangements for FFSPs remain in a transitional period. For further information, see The Foreign Financial Service Providers (FFSP) Regime in **4.1 Recent Developments and Proposals for Reform**.

2.3.4 Regulatory Approval Process

A regulated fund (typically an Australian unit trust) is known as a registered managed investment scheme, meaning it is registered with ASIC. The registration process is relatively straightforward and only requires that:

- the trustee of the fund holds an AFSL authorising it to be a "responsible entity" of a registered managed investment scheme;
- the responsible entity is an Australian public company; and
- the constitution of the fund meets the requirements of the Corporations Act.
- Once ASIC receives an application for registration, a decision on registration must be made within 14 days.

As previously noted, a limited partnership can be incorporated within approximately two business days. Registration of VCLPs and ESVCLPs can take as little as one month, assuming all required documents have been prepared. Registration fees are modest.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

In Australia, pre-marketing of alternative funds, like marketing of alternative funds, may involve providing financial services for which an AFSL will be required, subject to applicable exemptions.

Please refer to **2.3.3 Local Regulatory Requirements for Non-local Managers**, **2.3.6 Rules Concerning Marketing of Alternative Funds** and **2.3.7 Marketing of Alternative Funds**.

2.3.6 Rules Concerning Marketing of Alternative Funds

Marketing an alternative fund may involve providing financial services in Australia, for which an AFSL will be required, subject to applicable exemptions.

Non-local providers of financial services should refer to **2.3.3 Local Regulatory Requirements for Non-local Managers**.

2.3.7 Marketing of Alternative Funds

Alternative funds can be marketed in Australia as long as the person marketing the fund is authorised under an AFSL (or an exemption – see **2.3.3 Local Regulatory Requirements for Non-local Managers**) to provide financial product advice or to deal in the relevant fund interests to the relevant client group. Typically, these funds would be marketed to wholesale clients only.

If the person is not authorised to provide these services to retail clients, marketing activities must be limited to wholesale clients. In addition, where the fund is marketed to retail clients, it would usually need to be registered with ASIC as a "registered managed investment scheme" (see **2.3.4 Regulatory Approval Process**) and comply with regulated disclosure requirements (see **3.3.1 Regulatory Regime**) and associated rules applying to regulated products.

2.3.8 Marketing Authorisation/Notification Process

In Australia, marketing alternative funds may involve providing financial services, for which an AFSL will be required, subject to applicable exemptions. In these circumstances, depending on whether an AFSL will be required or an exemption is available, some form of prior authorisation or notification may be required to be made to ASIC.

For example, if it is determined that an AFSL is required, an application for an AFSL will need to be made to ASIC prior to any marketing activities taking place.

Alternatively, if it is determined that an exemption is available, then prior notification to ASIC may be required depending on the exemption.

Please refer to **2.3.3 Local Regulatory Requirements for Non-local Managers**.

2.3.9 Post-Marketing Ongoing Requirements

Once an alternative fund has been marketed to investors in Australia, certain ongoing requirements may need to be considered.

Certain activities in relation to the alternative fund (for example, issuing interests in the alternative fund to investors in Australia and providing reporting and information to such investors) may involve the provision of a financial service in Australia. In these circumstances, the fund operator may require an AFSL or be able to rely on an exemption.

If an AFSL is obtained, the licensed entity will be subject to ongoing statutory duties and obligations, including, for example, to:

- provide their services efficiently, honestly and fairly;
- manage conflicts of interest; and
- report "reportable situations" to ASIC.

Alternatively, if a relevant exemption was being relied upon, the conditions of that exemption would need to be complied with on an ongoing basis. For example, sufficient equivalence relief includes certain reporting requirements for ASIC.

Please refer to **2.3.3 Local Regulatory Requirements for Non-local Managers**.

2.3.10 Investor Protection Rules

Investor protection rules concerning financial services for wholesale clients primarily emphasise adherence to the conditions set by the Australian Financial Services Licence (AFSL) under which the financial services are provided (including compliance with relevant provisions of the Corporations Act, which encompasses restrictions against misleading and deceptive conduct).

Investor protection rules for financial services offered to retail clients include compliance with the abovementioned matters, as well as additional regulations aimed at safeguarding retail clients. These include requirements for membership in an alternative dispute resolution system and more detailed product disclosure rules.

Since October 2021, persons issuing and distributing financial products to retail clients have been subject to provisions of the Corporations Act known as the financial product "design and distribution obligations" (DDO). This has been a significant focus of the industry in recent times.

Under the new obligations, to ensure that their products are designed and distributed appropriately, issuers must make a target market determination (TMD) for each product that identifies, among other things, the intended class of consumers. They are then required to take "reasonable steps" that will (or are reasonably likely to) result in the financial product being distributed in a manner consistent with the TMD. Issuers are obliged to conduct reviews of the TMD periodically and keep certain records. Where there are significant dealings in the financial product that are inconsistent with the TMD, issuers are required to notify ASIC.

Distributors are also subject to certain obligations under the DDO – specifically to:

- not engage in retail product distribution unless they reasonably believe a TMD has been made or is not required to be made;
- take "reasonable steps" that will (or are reasonably likely to) result in distribution being consistent with the TMD;
- notify the issuer of significant dealings that are inconsistent with the TMD; and
- keep certain records.

2.3.11 Approach of the Regulator

ASIC plays an active role as the non-prudential regulator of the Australian financial services (AFS) industry. It conducts surveillance and enforcement of the industry and facilitates regulatory development and implementation.

ASIC's position on a range of regulatory matters is publicised via the ASIC website and other communication channels. Documents issued by ASIC include regulatory guides, information sheets and media releases.

Meetings between industry participants and ASIC occur from time to time in various contexts.

2.4 Operational Requirements

The key restriction applicable in relation to the operation of an alternative investment fund is licensing. Each entity involved in the fund's operation must hold or be authorised under a relevant AFSL or subject to or validly rely on an applicable exemption.

As previously noted, there are very few limitations applying to alternative funds. Significantly, for private equity funds, there are adverse tax implications if a trust were to control a business such that it would be designated a "trading trust". In such a case, the trust would potentially not be eligible to qualify as a managed investment trust and could be treated like a company (where the trust is widely held). The concept of "control" is currently widely interpreted for Australian income tax purposes.

Provided the fund's trustee is appropriately authorised under its AFSL, there is no legal requirement for a depository or a custodian to be appointed to hold its fund assets.

Specific operational requirements for AFSL holders include the following statutory obligations:

- providing financial services efficiently, honestly and fairly;
- having in place adequate arrangements for the management of conflicts of interest;
- complying with the conditions of the entity's AFSL;
- complying with the financial services laws of Australia;
- taking reasonable steps to ensure that their representatives comply with the financial services laws of Australia;
- having available adequate resources (including financial, technological and human resources) to provide the financial services covered by an entity's AFSL;
- maintaining competence to provide financial services; and
- ensuring that their representatives are adequately trained.

ASIC has issued guidance in relation to compliance with these obligations, and there are various practical ways in which AFSL holders may satisfy the obligations.

2.5 Fund Finance

The fund finance market in Australia is highly developed.

Restrictions on borrowings may arise due to the agreements that the fund equity holders have in place between themselves or as a function of the constituent documents of the fund. In addition, financier-imposed borrowing restrictions and covenants will be relevant.

It is common for financiers to take security for finance provided, including mortgages, in relation to property and infrastructure funds.

Alternative fund managers often utilise capital call facilities, which are secured by the unpaid capital commitments of the investors to the investment vehicle itself rather than the vehicle's assets. Certain large, institutional-grade investors do not support the use of capital call facilities. There are limited examples of funds raising debt via bond markets, which typically take place offshore.

2.6 Tax Regime

Taxation of a Trust

Typically, the income and gains of a trust are subject to flow-through tax treatment (ie, taxable income of a trust is taxed at the hands of the investors) and, therefore, investors are taxed directly on their pro rata share of the income of the trust and gains arising from the disposal of any investment of the trust.

In order to qualify as a "managed investment trust", broadly, the trust:

- must be managed by an AFSL holder;
- must be widely held;
- must not be closely held; and
- cannot control a trading business.

Where the trust qualifies and elects to be a "managed investment trust":

- fund payment distributions made by the managed investment trust to foreign investors may be subject to the concessional managed investment withholding tax of 15%; and
- investors' share of the gains arising from disposals of investments by the funds should be taxed under the capital gains tax provisions rather than be treated as a revenue gain (where the trust has made certain election) – as a result, a capital gains tax (CGT) discount may be available for eligible Australian resident investors.

Further detail is provided in **3.6 Tax Regime**.

Taxation of a VCLP or an ESVCLP

A VCLP or an ESVCLP provides fund managers and investors with support to help stimulate venture capital investments through tax benefits.

For a VCLP, the key Australian tax implications include:

- "flow-through" treatment – taxable income derived by the VCLP "flows through" the partnership to the investors and will be taxed in the hands of the investors; and
- CGT exemption – a full CGT exemption is available for eligible venture capital partners (ie, tax-exempt foreign residents or foreign venture capital funds) on gains derived from the disposal of EVCIs made by the VCLP (subject to satisfying certain requirements).

For an ESVCLP, the key Australian tax implications include:

- "flow-through" treatment – taxable income derived by the VCLP "flows through" the partnership to the investors and will be taxed in the hands of the investors;
- tax offset – a non-refundable carried-forward tax offset is available to investors for the lesser of 10% of their eligible contributions or share of investments in the ESVCLP (subject to satisfying certain requirements);
- revenue gain or profit exemption – any revenue gain or profit arising from the disposal of an EVCI by an ESVCLP will be excluded from the taxable income of an investor of the ESVCLP, which only applies if the revenue gain that arises would have been subject to the CGT exemption if the asset disposed of was a CGT asset (note that the exemption is capped where the relevant investment exceeds AUD250 million); and
- income exemption – an investor's share of income (eg, dividend) derived from EVCIs made by an ESVCLP will be excluded from the partner's taxable income calculation if the partner is a limited partner of an Australian-resident general partner.

Generally, a resident trust should be able to qualify for the benefits of a double tax treaty between Australia and a foreign jurisdiction. However, this should be considered on a jurisdiction-by-jurisdiction basis.

CCIVs

The new CCIV structure has been designed to provide tax treatment that aligns with the existing tax treatment of Attribution Managed Investment Trusts (AMITs). Investors in a CCIV sub-fund will receive the same tax treatment as those in an AMIT, including "flow-through" tax treatment.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Unit Trust

The most commonly used structure for retail funds in Australia is a unit trust. Each unit entitles the unit holder (ie, the investor) to a beneficial interest in the trust property as a whole but not in any particular asset comprising the trust property.

The trustee (which, in the context of retail funds, is referred to as a responsible entity) is responsible for the operation and management of the unit trust. As retail funds are regulated in Australia, the Corporations Act requires that the responsible entity be an Australian public company that holds an AFSL. For this reason, offshore managers looking to establish an Australian retail fund will often choose to engage a local responsible entity to manage the fund instead of creating their own responsible entity in Australia.

The responsible entity may then appoint an investment manager to oversee the fund's assets. The investment manager can be an offshore entity or a locally established (usually an Australian proprietary company limited by shares) subsidiary of an offshore manager. The investment manager, whether locally established or offshore, would generally need to obtain an AFSL or be able to rely on a relevant exemption. Please see **3.3.3 Local Regulatory Requirements for Non-local Managers** for further discussion regarding the local regulatory requirements for offshore managers.

Key Advantages and Disadvantages of Unit Trusts

Some of the key advantages of unit trusts are outlined below.

- Tax "flow-through" – unit trusts that have passive investments (and do not have active businesses) are typically managed as a flow-through vehicle for tax purposes, which means that, unlike a company, a unit trust does not itself pay tax. Rather, the unit holders of the unit trust will pay tax on their proportional share of the distributions to them.
- Asset protection – unit trusts offer additional asset protection from internal and external parties as the assets of the unit trust are held by the trustee on trust for the unit holders. The trustee is also subject to fiduciary and (as a responsible entity) statutory duties, including acting in the best interests of unit holders.

The perceived disadvantages of unit trusts include the following.

- Unit trusts are not common offshore – unit trusts tend to be creatures of common law jurisdictions, and hence, they are often only used or well understood in some offshore jurisdictions.
- No separate legal identity – unlike a company, a unit trust is not itself a separate legal entity

and therefore, any contracts relating to the fund will be entered into by the responsible entity. This can give rise to some additional complexities when applying the insolvency rules.

CCIVs

Amendments to the Corporations Act in 2022 have facilitated the emergence of an alternative fund vehicle to the unit trust, namely the CCIV. Please refer to **2.2.2 Legal Structures Used by Fund Managers** for further information.

3.1.2 Common Process for Setting Up Investment Funds

Registration Requirement

A retail fund in Australia will generally be required to be registered with ASIC as a managed investment scheme in accordance with Chapter 5C of the Corporations Act unless all investors are wholesale clients. Wholesale clients include:

- professional investors (for example, AFSL holders, trustees of superannuation funds with net assets of at least AUD10 million, or entities regulated by the Australian Prudential Regulation Authority);
- sophisticated investors (ie, persons regarded as having sufficient experience to assess the relevant investment);
- investors investing at least AUD500,000; and
- investors who met the requisite wealth test of net assets of AUD2.5 million or gross income of AUD250,000 in each of the previous two years.

Investors who do not satisfy one of the wholesale client tests are considered retail clients.

CCIVs and their sub-funds are also subject to a registration requirement under the Corporations Act, although it applies to retail and wholesale CCIVs.

Process and Documentation Required

To register a fund with ASIC, the responsible entity must lodge the following documentation with ASIC:

- a prescribed form including details of the responsible entity, fund, the auditor and compliance plan auditor;
- the constitution (ie, the trust deed) for the fund, which complies with the prescribed requirements in the Corporations Act and relevant ASIC guidance; and
- a compliance plan for the fund, which follows the prescribed requirements set out in the Corporations Act and relevant ASIC guidance.

Once an application for registration has been lodged with ASIC, ASIC has a statutory 14-day period to consider the application and register the fund or reject the application. During the 14-day registration period, ASIC will generally respond with queries and comments in relation to the constitution and compliance plan.

Despite the prescribed requirements for constitutions and compliance plans, the cost of preparing and lodging these documents with ASIC for registration is reasonable.

The registration process and documentation for a CCIV and its sub-funds are similar and include lodgement of the CCIV’s constitution and, in the case of a CCIV offered to retail clients, the compliance plan.

3.1.3 Limited Liability

The trust deed for most unit trusts includes what is, in effect, a contractual limitation of liability of investors. The effectiveness of such limitations has broad commercial acceptance. Despite such acceptance, the question of the legal effectiveness of such limitations has not been settled across Australia's states and territories.

CCIVs take the form of a company limited by shares, which means that the liability of each investor is limited to the value of their shares.

3.1.4 Disclosure Requirements

Product Disclosure Statement

The offer of interests in an Australian retail fund made to retail investors generally requires a PDS, except in certain limited circumstances. The PDS must comply with the prescribed content requirements in the Corporations Act and relevant ASIC guidance and include disclosure regarding the benefits, risks and fees associated with the fund.

Confirmations

As the issuer of the Australian retail fund, the responsible entity (or corporate director in the case of a CCIV) is required to provide retail clients with specific confirmation statements. These statements are generally related to transactions where a retail client acquires (or redeems some or all of their already-owned) interests in the fund.

Ongoing and Continuous Disclosure Requirements

The issuer of an Australian retail fund will also have continuous disclosure requirements, which they must comply with under the Corporations Act. Broadly, these obligations require the issuer to disclose material changes, significant events and information that is not generally available and that a reasonable person would expect to have a material effect on the price or value of the interests in the fund (that is, influence persons who commonly invest in units in deciding whether to acquire or dispose of the interests).

Periodic Reporting

The issuer will have certain periodic disclosure requirements where the Australian retail fund is issued to retail clients. This generally involves providing retail clients with an annual periodic report detailing certain matters concerning their investment (for example, opening and closing balances, details of transactions during the reporting period and the return on investment).

Breach Reporting

In addition to the above disclosure and reporting requirements, the responsible entity or corporate director, as the holder of an AFSL, will also have an obligation to notify ASIC of certain breaches or likely breaches of its obligations under the Corporations Act and relevant financial services laws.

Certain changes to the breach reporting requirements commenced in October 2021. Further minor changes took effect on 20 October 2023. Please see **4.1 Recent Developments and Proposals for Reform** for further discussion about this.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

Investor demand in the Australian retail funds market continues to grow, with approximately AUD485.4 billion total funds under management as of the end of December 2023 (Australian Bureau of Statistics, Managed Funds, Australian, December 2023).

The size and steady growth of the market are largely underpinned by the compulsory superannuation contribution system in Australia that was introduced in the early 1990s.

3.2.2 Legal Structures Used by Fund Managers

Retail fund managers established in Australia are themselves typically structured as Australian proprietary companies limited by shares. However, fund managers' internal structures often provide that the Australian management entity may contract with other internal entities for the provision of investment management services to mitigate tax and legal exposure.

3.2.3 Restrictions on Investors

There are no restrictions on the types of investors that may be or are eligible to invest in an Australian retail fund that is a registered managed investment scheme. Therefore, retail and wholesale clients could invest in an Australian retail fund. Please see **3.1.2 Common Process for Setting Up Investment Funds** for further discussion on the definitions of "retail client" and "wholesale client".

3.3 Regulatory Environment

3.3.1 Regulatory Regime

The regulatory regime governing Australian retail funds includes three key areas: registration, disclosure and licensing requirements.

Registration

A retail fund in Australia will generally be required to be registered with ASIC as a managed investment scheme in accordance with Chapter 5C of the Corporations Act. A CCIV is also subject to registration requirements. Please see **3.1.2 Common Process for Setting Up Investment Funds** for further discussion regarding the process and documentation involved in applying for registration with ASIC.

As a registered managed investment scheme, the fund will be governed by the provisions in Chapter 5C of the Corporations Act and the fund constitution. Under Chapter 5C of the Corporations Act, the responsible entity and its officers will have certain statutory duties, including duties to:

- act honestly;
- exercise care and diligence; and
- act in the best interests of members.

Chapter 5C of the Corporations Act also governs the process by which a responsible entity may retire and be appointed as the responsible entity of the fund.

CCIVs are subject to similar requirements under Chapter 8B of the Corporations Act.

Notably, an Australian retail fund is not subject to any investment limitations or restrictions under the Corporations Act (although the introduction of the DDO in October 2021 means that some Australian retail funds may need to restrict the scope of their investments as part of considering the suitability of the product for its target market – please see **4.1 Recent Developments and Proposals for Reform**). Rather, the scope of investments and permitted assets is governed by and documented in the constitution and associated disclosure documentation.

Disclosure

The offer of units in an Australian retail fund to retail investors will generally require a PDS (ie, a regulated offer document), except in certain limited circumstances. The PDS must comply with the prescribed content requirements in the Corporations Act and relevant ASIC guidance and include disclosure regarding the benefits, risks and fees associated with the fund. Please see 3.1.4 Disclosure Requirements for further discussion regarding PDSs.

Licensing

The Corporations Act requires a person, regardless of whether they are local or from offshore, who "carries on a financial services business in Australia" to hold an AFSL covering the provision of such services unless an exemption applies. A person provides a financial service if, among other things, the person:

- provides financial product advice;
- deals in a financial product; or
- operates a registered managed investment scheme.

For these purposes, a unit in an Australian retail fund that is a registered managed investment scheme will be a financial product.

The entity or corporate director responsible for an Australian retail fund is required to hold an AFSL. The investment manager would also generally hold an AFSL or rely on an available exemption in order to provide these financial services.

3.3.2 Requirements for Non-Local Service Providers

As discussed in **3.3.1 Regulatory Regime, the Corporations Act** requires a person, whether local or from offshore, who "carries on a financial services business in Australia" to hold an AFSL covering the provision of such services unless an exemption applies. Depending on the scope and structure of the provision of the relevant services, a non-local service provider may need an AFSL or be able to rely on an exemption in order to provide their services to an Australian retail fund.

Australian Licensing Options

If a non-local service provider is deemed to be carrying on a financial services business in Australia, it will need to:

- obtain an AFSL; or
- consider whether there are any available exemptions.

Please see **2.3.3 Local Regulatory Requirements for Non-local Managers** and **4. Legal, Regulatory or Tax Changes** for further discussion.

Authorised Representative Exemption

One such exemption that may be available is for a person to be appointed as an authorised representative of a holder of an AFSL. This effectively enables the non-local service provider to provide the same financial services as the AFSL holder, and the AFSL holder will be responsible for the provision of the relevant financial services by the non-local service provider.

AFSL

If a non-local service provider cannot rely upon a suitable exemption, the non-local service provider will likely need to apply for an AFSL.

Registration as a Foreign Company

Additionally, to the extent that a foreign company, itself or through its agents, is carrying on business in Australia, Australian law will require that company to be registered with ASIC as a foreign company in Australia.

3.3.3 Local Regulatory Requirements for Non-Local Managers

Similar to as discussed in **3.3.2 Requirements for Non-local Service Providers**, any non-local manager that provides financial services in Australia would need to hold an AFSL or seek to rely on an alternative exemption, depending on the scope of the services and the category of clients to whom those services are provided.

Where a non-local manager manages an Australian retail fund, particular consideration will need to be given as to whom the services are provided.

If the non-local manager provides financial services directly to retail clients in Australia, it would likely be required to obtain an AFSL or be appointed as an authorised representative to cover the provisions of these services to retail clients.

For more information on the key licensing options/exemptions that may be available, please see **3.3.2 Requirements for Non-local Service Providers**.

3.3.4 Regulatory Approval Process

Applying for Registration

As discussed in **3.3.1 Regulatory Regime**, the regulatory approval process for an Australian retail fund is relatively straightforward. Once the requisite documentation (ie, the fund constitution and compliance plan) have been prepared, these are lodged with ASIC for its consideration. In the case of a registered managed investment scheme, ASIC has a statutory 14-day period to consider the application and register the fund or reject the application. During the 14-day registration period, ASIC will generally respond with queries and comments in relation to the constitution and compliance plan.

Applying for an AFSL

As discussed in **3.3.2 Requirements for Non-local Service Providers**, separate from registering the fund with ASIC, and depending on the structure and scope of services to be provided in relation to the fund, an AFSL may be required for the investment manager and will be required for the responsible entity or corporate director. The process of applying for an AFSL can be relatively lengthy and involves preparing a number of documents to be submitted to ASIC. Preparing an application, lodging it with ASIC, and obtaining the AFSL can take six to eight months or more.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

In Australia, pre-marketing of retail funds, as with marketing of retail funds, will likely involve the provision of financial services in Australia, for which an AFSL will be required, subject to applicable exemptions.

Please refer to **3.3.2 Requirements for Non-local Service Providers**, **3.3.3 Local Regulatory Requirements for Non-local Managers**, **3.3.6 Rules Concerning Marketing of Retail Funds** and **3.3.7 Marketing of Retail Funds**.

3.3.6 Rules Concerning Marketing of Retail Funds

Similar to as discussed in **3.3.2 Requirements for Non-local Service Providers** and **3.3.3 Local Regulatory Requirements for Non-local Managers**, an entity (whether local or offshore) that is involved in or engages in the marketing of an Australian retail fund to Australian clients (whether retail clients or wholesale clients) will need to consider its Australian licensing options, because the activity of marketing the fund will likely involve the provision of financial services (in particular, financial product advice, as well as potentially dealing or arranging for dealing in financial products).

3.3.7 Marketing of Retail Funds

The Corporations Act places no restrictions on the types of investors to whom an Australian retail fund can be marketed. Consequently, a registered managed investment scheme in Australia can be marketed to any individual within the country. However, the entity promoting the fund must either possess an appropriate AFSL or be able to rely on an available exemption that authorises it to offer the relevant financial services to both retail and wholesale clients.

The introduction of the DDO in October 2021 means that some Australian retail funds must ensure their marketing activities comply with the new obligations. Please see **4.1 Recent Developments and Proposals for Reform** for further discussion.

3.3.8 Marketing Authorisation/Notification Process

In Australia, marketing of retail funds may involve the provision of financial services in the country, for which an AFSL will be required, subject to applicable exemptions. In these circumstances, depending on whether an AFSL will be required or an exemption is available, some form of prior authorisation or notification may be required to be made to ASIC.

For example, if it is determined that an AFSL is required, an application for an AFSL will need to be made to ASIC prior to any marketing activities taking place.

Alternatively, if it is determined that an exemption is available, depending on the exemption, prior notification to ASIC may be required.

Please refer to **3.3.3 Local Regulatory Requirements for Non-local Managers**.

3.3.9 Post-Marketing Ongoing Requirements

Once a retail fund has been marketed to investors in Australia, certain ongoing requirements may need to be considered.

Certain activities related to the retail fund (for example, issuing interests in the retail fund to investors in Australia and providing reporting and information to such investors) may involve providing a financial service in Australia. In these circumstances, the fund operator may require an AFSL or be able to rely on an exemption.

If an AFSL is obtained, the licensed entity will be subject to ongoing statutory duties and obligations, including, for example:

- providing their services efficiently, honestly and fairly;
- managing conflicts of interest; and
- reporting “reportable situations” to ASIC.

Alternatively, if a relevant exemption was being relied upon, the conditions of that exemption would need to be complied with on an ongoing basis. For example, sufficient equivalence relief includes certain reporting requirements to ASIC.

Please refer to **3.3.3 Local Regulatory Requirements for Non-local Managers**.

3.3.10 Investor Protection Rules

Investor protection rules in relation to financial services provided to a retail client in an Australian retail fund are primarily focused on compliance with the conditions applicable to the AFSL under which the relevant financial service is being provided. This includes compliance with the Corporations Act, which prohibits unconscionable conduct and engaging in misleading, deceptive or dishonest conduct.

The investor protection rules also include provisions designed to protect retail clients. In addition to the prescribed product disclosure requirements discussed in **3.1.4 Disclosure Requirements**, these include obligations regarding dispute resolution systems, compensation and breaches of PDS obligations.

In addition to the above, the new DDO regime applies to product issuers and distributors. Please see **4.1 Recent Developments and Proposals for Reform**.

3.3.11 Approach of the Regulator

The provision of financial services in Australia is regulated and licensed by ASIC, which is an independent Australian government body established and administered under the Australian Securities and Investments Commissions Act 2001 (Cth) (the “ASIC Act”).

ASIC’s relationship with entities that are licensed or providing financial services in Australia is generally of an ad hoc nature, as opposed to an ongoing one, and usually arises in the context of specific circumstances or matters (for example, in response to lodgement of a breach report). While entities will generally not be assigned a designated officer for their relationship with the regulator, it is often possible to reach out to ASIC to discuss or obtain feedback on certain matters.

3.4 Operational Requirements

There are a number of operational requirements that should be considered in the context of an Australian retail fund.

Obligations as a Responsible Entity of an Australian Retail Fund

An Australian retail fund structured as a registered managed investment scheme must be operated by its responsible entity in accordance with its constitution, compliance plan and the provisions of the Corporations Act. While the Corporations Act does not prescribe the types of assets that may be held by, or the types of investors that may invest in, an Australian retail fund, as discussed in **3.1.2 Common Process for Setting Up Investment Funds**, the Corporations Act does prescribe certain matters to be addressed in the content of the constitution and compliance plan. ASIC provides additional guidance in relation to these matters.

From an operational perspective, some of the key considerations will include:

- the issue and redemption pricing for units in the fund;
- the valuation of fund assets; and
- the holding of fund assets by the responsible entity itself or a custodian.

Similar to a registered managed investment scheme, a retail CCIV must be operated by its corporate director in accordance with its constitution, compliance plan and the provisions of the Corporations Act.

Obligations as an AFSL Holder

As an AFSL holder, the Australian retail fund’s responsible entity or corporate director will be required to comply with certain statutory obligations. Please see **2.4 Operational Requirements**.

ASIC provides guidance regarding compliance with these requirements, which should be considered when developing relevant policies and procedures to address these matters.

Other Operational Considerations

Other operational obligations and requirements that will need to be considered include:

- anti-money laundering and counter-terrorism financing;
- insider dealing and market abuse;
- short selling; and
- derivatives transaction reporting.

3.5 Fund Finance

There continues to be strong growth and competition in the Australian fund financing market, providing greater accessibility to retail funds looking to borrow or leverage their portfolio. The Australian domestic banks tend to be the key players; however, offshore commercial and investment banks are increasingly active in the fund financing market.

The facilities are usually provided on a bilateral basis, as opposed to a syndicated basis, and the lender will take some form of security (for example, over the assets of the fund or in the form of a guarantee). The fund financing documentation will also often impose certain limitations and restrictions on the use of the borrowings.

In terms of the fund documentation itself, a key consideration will be to ensure that the constitution of the fund permits the responsible entity to borrow and grant security over the fund's assets.

3.6 Tax Regime

Overview of Tax Regime

The tax regime applying to Australian retail funds structured as a unit trust is comprehensive and complex and should be carefully considered when establishing a fund in Australia. The Australian Taxation Office (ATO) is responsible for administering the federal tax laws in Australia.

Typically, the income and gains of a trust are subject to flow-through tax treatment, which means that the taxable income of a trust is taxed in the hands of the investors and not the trust itself. Therefore, investors are taxed directly on their pro rata share of the trust's income as well as gains arising from the disposal of any investment of the trust and on any disposal of their interests in the trust.

For Australian income tax purposes, different kinds of investors are subject to different taxation principles and taxation rates – for example:

- corporates are taxed at the corporate tax rate (generally 30% unless a complying small business):
- individuals are taxed at the relevant marginal tax rate (the highest being 45%); and
- complying superannuation funds are taxed at a rate of 15%.

Tax concessions may be available for foreign pension funds and sovereign wealth funds.

Where an Australian resident investor has derived a capital gain from its investment in a trust (ie, as a result of a disposal of either a capital asset by the trust or disposal of an interest in the trust), the capital gain could be subject to a discount where the relevant asset has been held for at least 12 months and the investor is a qualifying taxpayer (ie, not a company).

Where a non-resident investor has derived a capital gain from its investment in a trust (ie, as a result of either disposal of a capital asset by the trust or disposal of an interest in the trust), the capital gain could be exempt if the relevant asset is not taxable Australian property (TAP). TAP is generally limited to interests in land and certain interests in land-rich entities. No capital gains discount is available for non-resident taxpayers.

Where a non-resident investor disposes of an asset that qualifies as TAP (eg, interest in a land-rich Australian fund), the purchaser will be required to withhold 12.5% of the purchase price and remit this amount to the ATO. The non-resident investor may be able to claim a tax credit for the amount withheld (which could be refundable if the tax liability of the non-resident investor is lower than the withheld amount).

Managed Investment Trust

Where the trust qualifies and elects to be a "managed investment trust" (MIT), certain MIT tax concessions are available, including those stipulated in **2.6 Tax Regime**.

Broadly, to qualify as an MIT, the trust must satisfy the requirements specified in **2.6 Tax Regime**.

AMIT

The attribution management investment trust (AMIT) regime provides for taxation on an attribution basis as opposed to distributing funds on a distribution basis and is designed to provide greater flexibility for trusts and fairness for their investors. Under the AMIT regime, investors are taxed on income that is attributed to them on a "fair and reasonable basis" for each financial year, and the trust would not be liable to tax, provided all its taxable income is attributed to investors.

CCIVs

A detail of the new CCIV structure is provided in **2.6 Tax Regime**.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

There have been numerous legal and regulatory developments and proposals for reform in the financial services industry in Australia in recent years, including some arising from the recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the "Royal Commission").

Some of the key areas of development and proposals for reform impacting the Australian funds market are as follows.

The Design and Distribution Obligations Regime

The DDO regime commenced on 5 October 2021. This new regime applies broadly to the distribution of retail products and does not apply to non-retail client products, such as wholesale investment funds. Please see **2.3.10 Investor Protection Rules** and **3.3.10 Investor Protection Rules** for further information.

The introduction of the DDO regime represented a fundamental shift in retail consumer protection in financial services and has allowed ASIC to move quickly to respond to potential retail consumer harm. Since July 2022, ASIC's approach to DDO has moved from facilitation to enforcement, and as of late September 2024, ASIC had issued approximately 88 interim stop orders after finding deficiencies in the TMDs of product issuers, including issuers of investment funds and non-compliance with the reasonable steps obligation associated with distribution. Generally, interim stop orders prevent a product provider from issuing interests in a fund, giving a PDS for a fund or providing general advice to retail clients about an investment in a fund. The product issuers are expected to address ASIC's concerns promptly; otherwise, ASIC will consider making a final order.

Report 795

ASIC published Report 795, "*Design and distribution obligations: Compliance with the reasonable steps obligation*", in September 2024, which sets out some of ASIC's key observations arising from its recent DDO surveillance and enforcement activities. The observations primarily relate to an issuer's obligation to take reasonable steps that will (or are likely to) result in distribution being consistent with the TMD and include the following:

- issuers should check that a distributor has the capacity to distribute a product in accordance with the TMD before selecting them;
- issuers should ensure that staff involved in the distribution of a product receive sufficient training to ensure distribution is consistent with the TMD;
- issuers should ensure that their overall marketing strategy and the content and marketing channel for any marketing and promotional materials are aligned with the TMD;
- where a distributor decides that it is appropriate to use a questionnaire as part of complying with their reasonable steps obligation, they should ensure it is effective for the product, considering all relevant factors; and
- issuers should use existing information or data about a consumer or class of consumers (where available) when taking reasonable steps to direct the distribution of a product to the target market.

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The report also shares some observations in relation to reliance on poor-quality questionnaires by issuers of investment products.

Greenwashing – ASIC INFO sheet 271

ASIC is seeking to support effective climate and sustainability governance and disclosure, and its regulatory focus is responding to the growth in sustainability-related investments. This growth has been stimulated by the global trend of capital markets aligning with sustainability goals, but ASIC is concerned that poor governance and disclosure will result in an increased risk of greenwashing.

In June 2022, ASIC issued Information Sheet 271, titled "*How to Avoid Greenwashing When Offering or Promoting Sustainability-Related Products*" ("INFO 271"). In 2023, ASIC began enforcing the principles outlined in this document. Additionally, ASIC has included this topic as a continued area of focus in its current corporate plan. The principles in INFO 271 are underpinned by misleading and deceptive conduct law derived from the Corporations Act and the ASIC Act. INFO 271 defines greenwashing as the practice of misrepresenting the extent to which a financial product or investment strategy is environmentally friendly, sustainable or ethical. INFO 271 provides nine principles ("Principles") that ASIC considers should be taken into account when preparing communications regarding sustainability-related products, as follows.

- Is the product true to the label? – Sustainability-related labels must reflect the substance of the product and the underlying investment strategy, stewardship approach and asset holdings.
- Has vague terminology been used? – ASIC cautions against broad, sustainability-related

statements or "jargon", including "socially responsible" and "ethical investing".

- Are headline claims potentially misleading? – Sustainability-related "headline claims" should not be misleading or inconsistent with other disclosure document information.
- How are sustainability-related factors incorporated into investment decisions and stewardship activities? – Issuers are to specify the sustainability-related considerations taken into account and how they are incorporated into investment decisions and activities.
- Has a clear explanation of investment screening been provided? – Disclosures must contain sufficient detail to enable investors to understand the product's sustainability-related screening criteria and how this is applied, including whether the particular investment screen applies only to a certain product or to the issuer as a whole.
- Is there a clear explanation of the issuer's level of influence over the relevant benchmark? – Issuers should disclose their level of influence when influencing the composition of an index against which portfolio composition is determined, or performance is measured.
- Is a clear explanation of sustainability metrics provided? – Issuers relying on sustainability-related metrics in assessing whether an investment aligns with their product's stated objective/strategy should disclose the extent of metrics involvement, sources of metrics and a description of underlying data and risks/limitations.
- Are there reasonable grounds for sustainability targets? – Products with sustainability targets attached should explain:
  (a) what the target is;
  (b) how and when it is expected to be reached;
  (c) measurement metrics; and
  (d) any assumptions relied on when setting targets/measuring progress.
- Is information readily accessible? – Investors should have ready access to "adequate information, concise and clear enough to understand the sustainability-related considerations incorporated into the product". This information should be "consistent across all mediums".

ASIC has now provided additional guidance as to the interpretation of the principles through enforcement action. Key takeaways from this enforcement action include the following.

- When applying an investment screen, specificity as to the extent of the applicable exclusion is essential.
- Whether investment screening is a key facet of a bespoke investment strategy or is part of a broader investment policy, the same level of screening specificity is required.
- Where third-party data providers are relied upon for investment screening purposes, issuers must be aware of the scope and accuracy of that data as is captured by the INFO 271 principles.
- ESG disclosure must be consistent across all platforms, including disclosure documents, websites and social media.
- Disclosures made prior to INFO 271 being issued in June 2022 are subject to the principles, as the law underpinning the principles has not changed.

On 23 August 2024, ASIC released Report 791, "*ASIC's interventions on greenwashing misconduct: 2023–2024*", outlining its recent greenwashing interventions. The report summarises the high-level findings, key recommendations and good practice examples identified from ASIC's greenwashing surveillance activities during the financial year 2023–2024.

ASIC is expected to continue its focus on greenwashing in 2025, with greenwashing and misleading conduct involving ESG claims being one of its strategic priorities.

Report on the Updated Breach-Reporting Rules

The new breach-reporting rules for AFS licensees came into effect on 1 October 2021, arising from amendments to the Corporations Act, as inserted by the Financial Sector Reform (Hayne Royal Commission Response) Act 2020 (Cth). The reforms sought to address recommendations made by the Royal Commission that called for the strengthening and clarifying of the breach-reporting regime for financial services licensees.

Under the new breach-reporting rules, ASIC is required to publish an annual report stating its observations arising from the breach reports received.

ASIC published its third insights report in October 2024 in relation to the reports lodged with ASIC by licensees under the regime between 1 July 2023 and 30 June 2024. The report focuses on insights regarding the following:

- the volume of reports and nature of lodgers;
- the subject of the reports and root causes of the breaches;
- the identification and investigation of breaches; and
- customer impact, remediation and rectification of breaches.

Some of the key insights shared by ASIC in Report 800 included that:

- the overall volume of reports decreased by 27% from the previous period;
- AFS licensees reported more than credit licensees, and larger AFS licensees lodged a higher proportion of reports compared to smaller AFS licensees;
- most reports were about a financial service, credit activity or product line;
- the most notable change during the reporting period was an increase in the number of reports relating to superannuation;
- false or misleading statements remained the most common category of issues to which reports related;
- staff negligence and/or error continued to be the most common root cause of breaches;
- most breaches were identified through staff reports or business unit reports;
- of concern, breaches identified from internal sources, such as internal compliance activities, decreased;
- the time taken for licensees to identify and commence an investigation into a breach increased;
- a significant proportion of breaches involved customer financial loss;
- licensees generally took less time on average to remediate affected customers;
- staff training continued to be the most common rectification method; and
- significant variability was observed in the time taken to rectify breaches.

Undoubtedly, breach reporting will remain an area of focus for ASIC.

The Foreign Financial Service Providers (FFSP) Regime

The FFSP regime has been in a state of regulatory uncertainty following a prolonged period of ongoing transitional arrangements.

By way of background, in Australia, FFSPs to wholesale clients have historically been able to benefit from class order relief, exempting them from the need to hold an AFSL, including by virtue of the "sufficient equivalence" relief (also known as "passport relief") and "limited connection" relief, subject to transitional arrangements.

Since then, there has been further consultation and draft legislation in relation to the FFSP regime, most recently resulting in the Treasury Laws Amendment (Better Targeted Superannuation Concessions and Other Measures) Bill 2023 being introduced to Parliament in November 2023. This Bill, which was recently split out into a further Bill (containing the FFSP exemptions), seeks to introduce:

- a comparable regulator exemption – similar to ASIC's current "sufficient equivalence" relief, this will be available to FFSPs that provide financial services to wholesale clients and that are regulated by regulators approved by the Government (and not ASIC as is currently the case);
- a professional investor exemption – available where:
  - (a) an FFSP provides a financial service to a "professional investor";
  - (b) the service is provided from outside Australia or during a permitted "marketing visit"; and
  - (c) the FFSP reasonably believes that providing the same or similar service would not contravene any laws in the location where it is provided from or where the FFSP's head office and principal place of business are located (it will replace ASIC's current "limited connection" relief);
- a market maker exemption – available where an FFSP is making a market for derivatives that can be traded on a licensed market prescribed by the regulations from outside Australia (exchange-traded futures only), and the FFSP reasonably believes that making a market in derivatives would not contravene any laws in the location where it is provided from or where the FFSP's head office and principal place of business are located;
- an exemption from the fit and proper person assessment – available to FFSPs authorised to provide substantially the same financial services in a comparable regulatory regime to wholesale clients to fast-track the licensing process.

If passed, the exemptions are proposed to take effect on 1 April 2025. However, there is some uncertainty in relation to this date, given that Parliament will not sit again until early in 2025. During this transition period, ASIC has extended relief to enable FFSPs to continue relying on passport relief. Currently, FFSPs that relied on this relief exemption before 31 March 2020 may continue to do so until 31 March 2026. For FFSPs not relying on the relief at this date, ASIC will consider individual temporary relief applications seeking relief in the same form as the passport relief.

FFSPs may also still rely on limited connection relief to provide financial services to wholesale clients in Australia until 31 March 2026. This relief allows FFSPs operating outside Australia to provide financial services to wholesale clients in Australia.

Please see **2.3.3 Local Regulatory Requirements for Non-local Managers** for further discussion regarding the FFSP regime.

Unfair Contracts Regime

Following a 12-month transition period, on 9 November 2023, the updated unfair contract terms (UCT) regime commenced. Reforms to the Competition and Consumer Act 2010 (Cth) and the ASIC Act 2001 (Cth) now mean there are significant consequences for using or relying on unfair terms in a standard-form consumer or small business contract. Businesses now face substantial penalties for contravening the updated laws, and with each unfair term forming a separate contravention, there could be multiple contraventions in a single contract. Penalties up to AUD50 million or more, depending on the benefit obtained from the conduct, could be imposed for each contravention.

ASIC updated its guidance material on UCTs in INFO 210 (for consumers) and INFO 211 (for small businesses) following the commencement of significant changes to the UCT regime.

In summary, a standard-form contract is a contract that has been prepared by one party to the contract (the business offering the product or service) without negotiation between the parties. It could apply even when the other party has the opportunity only to negotiate minor changes or where changes are permitted but only from a range of pre-prepared options. A term of a standard-form contract could be "unfair" if it:

- would cause a significant imbalance in the parties' rights and obligations arising under the contract;
- is not reasonably necessary to protect the legitimate interests of the party that would benefit from the term; or
- would cause detriment (financial or otherwise) to a small business if it were to be applied or relied on.

There is an exception that applies to the funds management industry. The UCT regime does not apply to a contract that is the constitution of a managed investment scheme. However, if the contractual arrangements fall outside the scheme's constitution, the product issuer might still be caught.

One feature of the reforms was that they expanded the small business class that can rely on UCT protections. A business will be a small business if it either:

- employs fewer than 100 people; or
- has a turnover of less than AUD10 million for the previous income year.

If a contract relates to financial products and services, there is a monetary cap on the upfront price of AUD5 million. For other types of contracts, there is no cap. The definition of "small business" has led to some unintended consequences, particularly affecting a few large, sophisticated financial services entities that the reforms have impacted. The authors believe that both ASIC and the industry are concentrating on these issues, especially in situations where transactions occur between two institutional parties.

Enforcing UCT Regime Among ASIC's 2023 Priorities

Following the commencement of the UCT reforms, the Australian Financial Markets Association (AFMA) made an urgent application to ASIC for no-action relief in advance of the changes to the UCT regime, citing concerns on behalf of industry that the amended regime would apply to certain sophisticated participants in financial markets who are not consumers or small businesses intended to be covered by the regime. Following consultation with the Treasury, AFMA and industry participants, ASIC granted a limited class no-action position for institutional markets on 6 February 2024.

The no-action letter means that ASIC does not intend to take action for a contravention of the relevant UCT provisions or related obligations regarding the class of counterparties and standard form contracts outlined in the no-action letter. However, the no-action letter does not prevent third parties (including the Director of Public Prosecutions) from taking legal action in relation to the conduct it outlines.

Trends and Developments

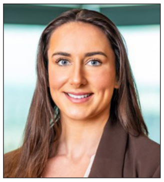
Contributed by:
Michael Lawson, Nicole Brown, Lizzie White and Tamaryn Leach
MinterEllison

MinterEllison is a law firm operating across mainland Australia, New Zealand, Hong Kong, China, and the UK through a network of integrated and affiliated offices. MinterEllison's global reach is bolstered by a network of international offices and deep, longstanding relationships with leading independent law firms around the world. The firm is recognised as having one of the largest and most specialised financial services practices in Australia. The funds team comprises over 40 qualified practitioners with a strong understanding of the financial services regulatory environment and active participation in industry working groups. Their expertise includes fund formation, fundraising, regulatory compliance, third-party engagement, investment advice, investor negotiations, and project management. MinterEllison has advised clients such as Next Capital, Quadrant Private Equity, and Metrics Credit Partners on innovative fundraising methods. The team also collaborates with major firms like BlackRock, Vanguard, and Macquarie on investment management, particularly in exchange-traded funds and A-REITs.

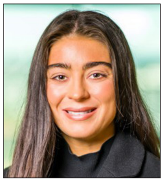
Authors

Michael Lawson is a partner and leads MinterEllison's financial services and funds group. He has advised Australian and global fund managers on all aspects of funds management and financial services for over 20 years. He has broad industry experience across domestic and international financial products, including retail and institutional funds, A-REITs, ETFs, structured products, private equity funds, hedge funds and infrastructure funds. Michael's expertise spans the development, formation and promotion of listed and unlisted investment funds, restructures of existing products, counterparty arrangements and regulatory issues. Before joining MinterEllison, Michael was part of the magic circle of Clifford Chance's market-leading funds management team in London.

Nicole Brown is a partner in MinterEllison's financial services and funds group. Nicole specialises in funds management and financial services. She has experience in advising fund managers, investment managers, responsible entities, trustees and other financial services entities in relation to a variety of financial services and funds management issues, including establishing, structuring, promoting and marketing funds. Nicole's experience covers a range of products, including retail funds, wholesale funds, exchange-traded funds and hedge funds. Her experience also includes several years with Baker McKenzie in London in its financial services team.



Lizzie White is a lawyer in MinterEllison's financial services and funds group. Having transitioned from a graduate role at the firm, she has experience in a broad range of practice areas, including financial services licensing, consumer protections, payment systems, consumer credit, product disclosure, prudential standards and privacy. She has assisted in providing advice to various entities, including financial institutions, insurers, fund managers and payment service providers.



Tamaryn Leach is a lawyer in MinterEllison's financial services and funds group. She has a broad range of experience in the financial services industry, including in financial services and credit licensing, consumer protections such as unfair contract terms, payment systems and regulations, consumer credit, anti-money laundering and counter-terrorism financing, sanctions, product disclosure, prudential standards, design and distribution obligations, scams, cybersecurity and privacy. She has been involved in due diligence projects from a regulatory perspective and in providing advice to various financial services entities, including banks, insurers, fund managers and payment service providers.

MinterEllison

Level 40, Governor Macquarie Tower
1 Farrer Place
Sydney 2000
Australia

Tel: +61 299 218 888
Fax: +61 299 218 123
Web: www.minterellison.com

MinterEllison.

AUSTRALIA TRENDS AND DEVELOPMENTS

Contributed by: Michael Lawson, Nicole Brown, Lizzie White and Tamaryn Leach, **MinterEllison**

The Australian investment fund landscape has seen a number of trends and developments over the past 12 months from both a commercial and regulatory perspective.

Commercial Trends and Developments

The Australian market is increasingly shifting away from intermediated retail investing, with fund managers seeking more direct ways to reach retail investors. There is notable growth in the exchange-traded fund (ETF) market as traditional fund managers explore exchange-traded structures, particularly for active or bespoke strategies. Retail investors seek access to a more diverse range of investment offerings at competitive price points.

There has been increasing interest in the dual access structure for ETFs, with fund managers wanting to take advantage of the benefits and flexibility provided by the structure. This structure allows a financial product issuer to offer the product as an ETF (by quoting units in the fund on an exchange like the ASX) while also allowing applications and redemptions off-market. Dual access mechanics and infrastructure are increasingly being considered and built into new products, even where the structure is not immediately utilised, to allow fund managers the flexibility to offer this access when demand arises.

Regulatory Trends and Developments

ASIC's focus on enforcement

In its 2024-25 Corporate Plan, the Australian Securities and Investments Commission (ASIC) outlines its two main objectives for taking enforcement action: to hold individuals and companies accountable and to deter future misconduct. This approach involves focusing on types of misconduct that impact a large number of consumers, as well as pursuing substantial penalties and sentences through the courts. Over the previous year, ASIC has bolstered its enforcement efforts, increasing new investigations by 25% and civil proceedings by 23%.

Each year, ASIC identifies its key enforcement priorities. On 14 November 2024, Deputy Chair Sarah Court announced that ASIC's enforcement in 2025 would concentrate on 12 key areas – with consumer protection being at the forefront, especially given the heightened cost of living challenges. Within the realm of financial markets, Ms Court declared ASIC's unwavering commitment to maintaining the integrity of Australia's financial markets, supported by a newly established team dedicated to insider trading. Additionally – and of particular relevance to Australian funds market participants – ASIC has expressed its commitment to addressing cybersecurity, greenwashing and misleading conduct involving ESG claims throughout 2025.

Existing participants (as well as new entrants) in the Australian funds market must adopt a customer-centric mindset. Implementing robust legal compliance processes to monitor their financial services activities is essential. Additionally, maintaining appropriate governance, oversight, and systems for these compliance processes is crucial.

Design and distribution obligations

ASIC has demonstrated that it continues to actively monitor DDO (The Design and Distribution Obligations) compliance and stands ready to act where necessary to prevent consumer harm. Since the obligations commenced, ASIC has instigated civil penalty proceedings against five providers and has issued 88 interim stop orders and one final stop order under the DDO regime. Enforcement action targeting poor distribution of financial products was an ASIC enforcement priority in 2024, and the regulator has indicated that it will continue to take regulatory action for contraventions of the DDOs where warranted, including where there is a high risk of consumer harm. ASIC's initial DDO enforcement action centred on Target Market Determination content requirements; however, the regulator's recent focus has been in relation to the "reasonable steps" obligation.

In simple terms, the DDO regime requires issuers of financial products to "retail" clients to design their products to meet consumer needs and for distributors of those products to distribute them in a more targeted manner. The intervention by ASIC can be quite disruptive, impacting operations and the continuity of products. A product issuer's reputation is also at risk, given that ASIC's approach is to publicly announce its regulatory findings, including the issuance of stop orders, which are typically picked up quickly by the financial press.

Accordingly, product issuers must ensure they have appropriate product governance arrangements in place through each stage of the product life cycle, including during product design, distribution, monitoring and review. ASIC expects that product governance arrangements would, among other things, include:

- an assessment of products against the likely objectives, financial situation and needs of the class of consumers for whom the product is intended;
- analysis of distribution methods;
- product testing;
- consideration of how consumer outcomes will be measured and monitored when the product is being distributed;
- a risk product distribution risk assessment; and
- regular monitoring and review of product performance and distribution.

ASIC has shown through its actions that where it identifies financial product issuers and distributors which, in its view, are not adopting a consumer-centric approach, it "will take quick action under DDO to disrupt poor conduct and prevent potential consumer harm".

ASIC has published a number of reports sharing their observations from the surveillance and enforcement activity, including the following reports:

- ASIC Report 754: Target market determinations for small amount credit contracts (Dec 2022);
- ASIC Report 762: Design and distribution obligations: Investment products (May 2023);
- ASIC Report 770: Design and distribution obligations: Retail OTC derivatives (Sep 2023); and
- ASIC Report 795: Design and distribution obligations: Compliance with the reasonable steps obligation (Sep 2024).

ESG and greenwashing

Further to ASIC publishing INFO 271 in 2022, the regulator continued its focus on ESG and greenwashing in 2023 and 2024. INFO 271 continues to provide a stringent framework of disclosure principles and standards to prevent greenwashing of financial services and products, with this framework leading to enforcement action by ASIC. From 1 July 2022 to 30 June 2024, ASIC has initiated several civil penalty proceedings in the Federal Court against issuers deemed to have engaged in potentially misleading disclosures. During this period, there have been a total of 60 corrective disclosure outcomes and 19 infringement notices issued.

INFO 271 complements ASIC's true-to-label and marketing review initiatives, requiring a high standard of clarifying disclosure for sustainability-related financial products. ASIC has emphasised the importance of transparency regarding claims and terminology related to ESG, "green" or "sustainable" products. They have made it clear that product issuers who use these claims or ESG labels must disclose and thoroughly explain them. INFO 271 sets out nine sustainability-related disclosure principles (Principles). These include:

- use of jargon terminology;
- misleading headline claims;
- disclosing sustainability-related measures, benchmarks and screens; and
- inadequate explanation of sustainability and stewardship claims.

Through enforcement of the Principles, ASIC has now provided additional guidance on their scope and application. One such example is Australian Securities And Investments Commission v Mercer Superannuation (Australia) Limited ACN 004 717 533 [2024] FCA 850, which, in particular, provides that ESG disclosure to investors and potential investors must be consistent across all platforms, transparent and accurate and that Australian financial services licensees and other market participants should exercise diligence in adhering to such claims. The outcome of the proceedings reveals that ASIC's scrutiny is not limited to disclosure documents but also includes websites and social media. Extra care should be taken with materials published online, noting that separate contraventions will occur on each occasion a representation is made (ie, each time the webpage is viewed).

The case Australian Securities and Investments Commission v Vanguard Investments Australia Ltd (No 2) [2024] FCA 1086 illustrates that ESG disclosures must be specific and verifiable based on relevant research or screening against the applicable ESG criteria. Additionally, it emphasises that ESG claims made in short-form mediums, such as social media, are also held to the same high standards. The case also provides that an organisation will still be responsible for the accuracy of any disclosures it makes, even where a third-party provider has been engaged for the index and ESG research. The limitations or rules of third-party indexes and methodologies should be clearly explained and disclosed to investors.

These enforcement actions taken by ASIC send a clear message to those providing financial services in Australia that the bar has been raised and more detail and disclosure are required to avoid greenwashing and, in turn, ASIC enforcement action.

Foreign financial services providers

A key area of interest for foreign investment managers is the state of play of the regime for regulating foreign financial services providers (FFSPs) in Australia.

The FFSP Regime has been in a state of regulatory uncertainty following a prolonged period of ongoing transitional arrangements.

By way of background, in Australia, FFSPs to wholesale clients have historically been able to benefit from class order relief, exempting them from the need to hold an AFSL (Australian Financial Services License), including by virtue of the "sufficient equivalence" relief (also known as "passport relief") and "limited connection" relief, subject to transitional arrangements.

On 1 April 2020, ASIC released a new regulatory framework for the foreign AFSL regime. This framework repealed the passport relief and limited connection relief previously available to FFSPs. In their place, a new funds management relief was introduced. The transitional period for the class order relief was extended, and a new foreign AFSL regime was confirmed.

In the 2021–22 Federal Budget, the Government announced it would "consult on options to restore previously well-established regulatory relief" from holding an AFSL for FFSPs licensed and regulated in jurisdictions with comparable financial services rules and obligations to, or limited connection with, Australia. In addition, the Government indicated that it would consult on options to create a "fast track" licensing process for FFSPs that wish to establish more permanent operations in Australia.

This announcement created uncertainty for the new FFSP regulatory framework introduced by ASIC, which was set to commence on 1 April 2022. The reforms were subject to criticism, and the Government undertook further consultations towards the end of 2021 and into early 2022.

In February 2022, the Treasury Laws Amendment (Streamlining and Improving Economic Outcomes for Australians) Bill 2022 (the "2022 Bill") was introduced into the Australian Parliament, providing two exemptions for FFSPs from the requirement to hold an AFSL, as follows.

- A new comparable regulator exemption sought to replace the passport relief but with some changes, including the fact that it would apply to all types of regulated financial services and products provided to wholesale clients. It would also apply to a broader range of regulators approved (by the Government and not ASIC) as sufficiently equivalent.
- A new professional investor exemption was designed to replace the limited connection relief but would require FFSPs to notify ASIC before relying on the exemption.

However, when the Government called an election in May 2022, the 2022 Bill, containing the above proposed new exemptions, lapsed.

On 7 August 2023, the Treasury announced new proposals to provide FFSPs with exemptions from the requirement to obtain an AFS licence by virtue of the Treasury Laws Amendment (Measures for Future Bills) Bill 2023 (the "August 2023 Bill"), for which consultation closed in September. The proposed legislation was akin to that previously tabled in Parliament, but with a few notable changes:

- the August 2023 Bill proposed to give the Government the power to stop FFSPs relying on the professional investor exemption in relation to dealings in financial products traded on prescribed markets ("dealing exclusion");
- a new exemption was proposed for making a market for derivatives that can be traded on a prescribed market;
- an additional condition would apply to all the exemptions to require that financial services are provided efficiently, honestly and fairly (with certain carve-outs); and
- an additional power would be conferred on ASIC to cancel an exemption on the grounds that the person is not providing financial services efficiently, honestly and fairly.

In November 2023, the proposed reforms to the FFSP licensing regime were introduced to Parliament in the form of a new bill, the Treasury

Laws Amendment (Better Targeted Superannuation Concessions and Other Measures) Bill 2023 (the "November 2023 Bill"). The November 2023 Bill includes some important improvements for FFSPs, with the Treasury taking on board industry feedback during the consultation period for the August 2023 Bill. Notable changes include that:

- the dealing exclusion was removed as a condition of the professional investor exemption; and
- the "efficiently, honestly and fairly" condition have been qualified such that they only apply where the FFSP carries on a financial services business, predominantly in Australia.

In the meantime, on 4 August 2023, ASIC released ASIC Corporations (Amendment) Instrument 2023/588 to extend the existing relief for FFSPs until 31 March 2025, the result being that FFSPs could continue to rely on the passport relief and limited connection exemptions for a further year. On 30 July 2024, ASIC extended the existing relief for FFSPs by another 12 months until 31 March 2026 by way of ASIC Corporations (Amendment) Instrument 2024/497. The decision was presumably made as a preemptive step to allow Parliament further time to consider the November 2023 Bill and undertake due process (if required).

Notably, the passport relief is only available to an entity if that entity was relying on the exemption before 31 March 2020. Because of this, ASIC has indicated that it will consider new temporary licensing relief applications for FFSPs that were not relying on the passport relief as of 31 March 2020.

FFSPs already validly relying on the passport relief (relief for FFSPs already covered by regulations sufficiently equivalent to those in Australia) can continue to do so until 31 March 2026. New applications for this relief can only be made under an application for individual relief in the same form as the passport relief (ie, providing an avenue for new FFSPs to have access to relief in the form of the passport relief).

FFSPs that have been granted a foreign AFSL can continue operating their financial services business in Australia, although ASIC has now paused consideration of new applications for foreign AFSLs.

FFSPs may still rely on the limited connection relief to allow them to provide financial services to wholesale clients in Australia until 31 March 2026. This relief allows FFSPs operating outside Australia to provide financial services to wholesale clients in Australia.

The November 2023 Bill (which was recently split into two separate Bills – the FFSP exemptions being contained in one of those) currently has a proposed commencement date of 1 April 2025. However, there is some uncertainty surrounding this date, given the Bill has yet to be passed by Parliament – and Parliament will not sit again until early 2025.

Cyber risk

Most fund managers generally have mature risk management systems and processes because they are a requirement of the Australian financial services licensing regime. However, with the frequency and sophistication of cyber-attacks on the rise, ASIC is calling on licensees to prioritise their cyber security risks. In fact, ASIC wants it to be a "top priority". This call to action follows ASIC Report 776, published in November 2023, summarising the results of a voluntary self-assessment survey and ultimately revealing that "organisations are reactive rather than proactive when it comes to managing their cyber security".

ASIC encourages the industry to focus on cyber "resilience" rather than cyber "security". That is, entities should have adequate arrangements in place to prepare for, detect, respond to and recover from a cyber-attack rather than focusing solely on prevention. ASIC has indicated that this should include oversight of cyber security risk throughout the fund manager's supply chain (eg, administrators, custodians, distributors, or third-party service providers). This is because ASIC recently found that "third-party relationships provide threat actors with easy access to an organisation's systems and networks".

Good practice on cyber resilience would include practices such as:

- ensuring boards are engaged with the cyber strategy and are increasingly educated about cyber resilience;
- tailoring governance processes to ensure "responsive governance";
- having proactive arrangements to prepare for, detect, respond to and recover from a cyber-attack;
- regularly reviewing crisis management arrangements, including incident response plans and recovery processes;
- regularly testing response plans and assumption to test for vulnerabilities;
- undertaking cyber risk management, including through collaboration and information sharing and third-party risk management;
- having centralised asset management systems;
- conducting audits to identify confidential and business-critical systems and data; and
- providing internal cyber awareness and training.

As outlined in its 2024-25 Corporate Plan, advancing digital and data resilience and safety is a current strategic priority for ASIC. The key activities that ASIC will undertake in relation to this strategic priority that are of relevance to participants in the Australian funds market include:

- implementing a supervisory cyber and operational resilience program. As part of this program, ASIC will conduct reviews of regulated entities' current cyber resilience and issue letters based on the findings of those reviews;
- monitoring licensees' use of artificial intelligence and their related risk management and governance arrangements;
- disrupting misconduct involving scams, including publishing findings on scam practices by licensees; and
- monitoring how investment managers manage the risks of using offshore service providers.

AML

Australia has embarked on a major upgrade to its anti-money laundering and counter-terrorism financing (AML/CTF) regime. The Anti-Money Laundering and Counter-Terrorism Financing (AML/CTF) Amendment Act 2024 was passed by Parliament in late November 2024.

The reforms aim to align Australia's AML/CTF regime with current international standards, including expanding the regime to capture a range of designated services which do not currently have AML/CTF obligations – these include certain professional services provided by lawyers, accountants, conveyancers, trust/company service providers and also property services including those provided by real estate agents and developers who sell property directly. Professional advisers who provide advice regarding establishing legal entities and trusts (or who assist in establishing entities and trusts) are intended to be captured under the AML/CTF Regime.

The reforms also aim to modernise the regime (ie, by including virtual assets) and streamline compliance. Existing rules will be replaced to provide a less prescriptive approach through new overarching obligations based on risk. This is intended to provide flexibility for reporting entities to implement risk-based systems and controls that suit their particular business. The changes reflect the Government's intention to dissuade tick-a-box compliance behaviour, instead requiring reporting entities to invest time and resources to consider their risks and implement appropriate controls and procedures properly. Risk assessment will be at the core of compliance programs under the new arrangements.

The reforms will come into force progressively, with the repeal of the Financial Transactions Reports Act 1988 taking effect from 7 January 2025, changes to "tipping off" offences commencing on 31 March 2025, changes for existing reporting entities starting on 31 March 2026 and providers of new designated services being expected to comply from 1 July 2026. AUSTRAC will likely prepare new AML/CTF Rules and supporting guidance for the updated regime and is expected to finalise these in 2025.

Mandatory climate-related financial disclosures

Since 1 January 2025, many large businesses and financial institutions in Australia have been obliged to comply with the new mandatory climate reporting requirements set out in the Treasury Laws Amendment (Financial Market Infrastructure and Other Measures) Bill 2024 (Cth), which was enacted in September 2024. The legislation makes climate reporting mandatory for all entities currently required to issue financial reports under Part 2M of the Corporations Act 2001 (Cth), which relevantly includes listed and unlisted companies and registered managed investment schemes.

The new regime will be implemented in phases, depending on an entity's number of employees, consolidated gross assets, and consolidated revenue. The largest emitters and corporations (Group 1, roughly equivalent to the ASX 200 and their private company counterparts) have been required to disclose information since 1 January 2025. Meanwhile, the smaller entities in Group 2 and Group 3 will be phased in starting from 1 July 2026 and 1 July 2027, respectively.

The mandatory disclosures must adhere to the AASB S2 standard, which is the Australian adaptation of the international climate standard, IFRS S2. The standard requires an entity to disclose information about climate-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, as well as its access to finance or cost of capital over the short, medium, or long term.

Alongside the mandatory AASB S2, the regime includes a general sustainability standard, AASB S1, which is based on IFRS S1 and intended to be used by organisations to disclose sustainability beyond climate (such as nature and biodiversity). While this standard is currently voluntary, the government has flagged that eventually, it may become mandatory as part of its "climate first but not only" policy.

Entities are expected to report the disclosures annually in a sustainability report. In addition, directors will be required to declare whether, in their opinion, their entity's disclosures are in accordance with the Corporations Act 2001 (Cth), including whether they comply with AASB S2. However, for the first three years, as a transitional measure, directors will be entitled to make a qualified declaration whereby they affirm that their entity has taken "reasonable steps" to comply with the regime.

Non-compliance with the mandatory reporting requirements may result in a civil penalty. Nevertheless, ASIC has acknowledged the need for a transitional period and has indicated that it will "take a proportional and pragmatic approach to supervision and enforcement as the industry adjusts to these new requirements."

Unfair Contract Terms

With the updated unfair contract term (UCT) regime in place, fund managers need to consider whether their contracts must comply with the regime, particularly given penalties of up to AUD50 million or more could be imposed for each contravention within a contract. It is important to note that while the constitution of a managed investment scheme is exempt from certain regulations, there may still be terms outside of the constitution that could be affected. For instance, fund managers should consider whether their application forms or the terms and conditions on their website or investor portals contain any potentially unfair terms. In addition, potentially unfair terms could be discovered in service provider or other scheme-related agreements.

Irrespective of this, on 2 February 2024, ASIC issued a class no-action letter in respect of "sophisticated participants in financial markets". The letter states that ASIC will not take action for a contravention of the unfair contract term provisions where:

- each counterparty to the standard form contract is an "institutional investor", which relevantly includes funds, trustees of funds, investment managers and unlisted investment companies, provided that the funds under management are at least AUD50 million, including any amount held or managed by an associate, and the funds are solely or principally engaged in the provision of financial services; or
- where each counterparty to an "industry standard form contract" (such as an International Swaps and Derivatives Association (ISDA) Master Agreement) is a "wholesale client", as defined by the Corporations Act 2001 (Cth), and the contract is used for the purpose of dealing in/related to dealing in financial markets.

It is important to understand that the no-action letter is a policy decision, not a legal opinion, and ASIC has reserved the right to take legal action or withdraw the letter at any time. Furthermore, the letter does not prevent third parties (including the Director of Public Prosecutions) from taking legal action in relation to the conduct that is the subject of the letter.

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Law and Practice

Contributed by:
Guilherme Bueno Malouf, Luciana Costa Engelberg, Bruna Marrara and Thales Saito
Machado Meyer Advogados

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Machado Meyer Advogados

Machado Meyer Advogados has an investment funds practice that is vastly experienced in handling matters relating to all kinds of funds, such as private equity funds (FIPs), asset-backed securities investment funds (FIDCs), infrastructure private equity funds (FIP-IEs), real estate investment funds (FIIs) and agriculture investment funds (FIAGROs). The firm handles the structuring and formation of the funds, the offering of fund quotas (public offerings) and the setting up of credit assignment frameworks under FIDC structures, as well as advising on funds governance and intricate regulatory matters. Machado Meyer's funds practice is enhanced by the expertise of the firm's partners and associates in other areas, and its impressive clientele includes banks, national and international funds, investment banks, hedge funds, fund managers and private equity funds.

Authors

Guilherme Bueno Malouf is the head of the business law department at Machado Meyer Advogados, which covers the firm's M&A and private equity, as well as corporate and capital markets practices. He is an expert in M&A transactions, private equity investments and the organisation of structured investment funds, especially private equity investment funds (FIP), real estate investment funds (FII) and asset-backed securities investment funds (FIDC). Guilherme has extensive experience in the food and beverage, steel, cement, real estate, energy, services, technology and retail sectors. In addition to serving as head of the M&A practice, he is also a member of the firm's Asian desk.

Luciana Costa Engelberg focuses on the investment funds practice at Machado Meyer Advogados and specialises in corporate law, M&A, and private equity transactions. She provides legal assistance in the structuring and implementation of investment funds, the offering of securities of investment funds (public offerings), the review and negotiation of M&A and private equity transactions, corporate law and corporate restructuring, joint ventures, asset purchases and sales, and structured transactions. Luciana has previous experience with the food and beverage, education, information technology, timber, pharmaceutical, paper and cellulose, services, agribusiness, printing, roadways and logistics industries.

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Machado Meyer Advogados

Bruna Marrara specialises in tax law, specifically providing consultancy related to direct taxes and international taxation. Her practice mostly consists of the structuring of investment acquisitions in Brazil, corporate reorganisations, the analysis of tax impacts arising from alternatives for raising funds and financial and capital markets transactions, in addition to the provision of support on the identification of the different business models adopted in infrastructure projects. She has previous experience in the renewable, food and beverage, mining, sugar and alcohol, telecoms, agribusiness and infrastructure sectors.

Thales Saito specialises in financial transactions, M&A, banking regulations, securitisation of receivables, incorporation of investment funds, derivatives and exchange regulations. His practice encompasses the rendering of legal assistance to local and international clients in the negotiation and implementation of corporate and financial transactions of different structures, including those related to the incorporation of investment funds and regulated activities.

Machado Meyer Advogados

Rua José Gonçalves de Oliveira
116 – 5th floor
01453-050
São Paulo, SP
Brazil

Tel: +55 113 150 7000
Fax: +55 113 150 7071
Email: machadomeyer@machadomeyer.com.br
Web: www.machadomeyer.com.br

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Contributed by: Guilherme Bueno Malouf, Luciana Costa Engelberg, Bruna Marrara and Thales Saito,
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1. Market Overview

1.1 State of the Market

The investment funds market in Brazil is very active and has become more sophisticated in the last decade – especially with the enactment of CVM Resolution 175 of 23 December 2022, which changed the regulatory framework applicable to investment funds in Brazil, as well as CVM Resolution 214 of 30 September 2024, which amended CVM Resolution 175 and created a specific regulation for agriculture investment funds.

The rise in the interest rate in the last couple of years, following a rise in inflation, has caused retail investors to avoid risks with variable-income investments, leading to further investment in fixed-income assets.

According to publicly available data published by the Brazilian Financial and Capital Markets Association (ANBIMA), a private and voluntary self-regulatory association, the consolidated net equity of investment funds amounted to BRL9.3 trillion as of 8 November 2024.

According to the latest ranking from the International Organization of Securities Commissions (IOSCO), Brazil is the fourth major capital market in the world in terms of the investment fund industry.

Notwithstanding the negative result in net funding in 2024 for the total funds industry, the alternative funds had positive results with investment in FIDCs totalling BRL33.8 billion and in FIPs totalling BRL27.5 billion until November 2024.

With the government's intention to increase the interest rates for 2025, the perspective for 2025 is positive for fixed-income investments.

The changes promoted by CVM Resolution 175 and recent tax reforms, which also brought beneficial changes for foreign investors, are expected to positively impact the investment fund industry in 2024.

CVM Resolution 175 represented an important milestone for the evolution of the fund industry in Brazil, intending to reduce bureaucracy and costs and increase security for investors, bringing the industry closer to practices adopted in other jurisdictions, including, eg, the limitation of the liability of investors (up to the limit of the value of their quotas), the creation of different classes of quotas with segregation of portfolios, and the application of insolvency rules provided for legal entities in general (ie, investment funds are directly responsible for their legal and contractual obligations).

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Investment funds in Brazil are regulated by CVM under federal laws No 6,385 of 7 December 1976 (Securities Law) and the Brazilian Civil Code. CVM is a governmental agency of the Ministry of Economy and is responsible, inter alia, for monitoring the investment fund industry and issuing regulations.

Resolution CVM 175 is composed of a general part applicable to all categories of investment funds in Brazil and annexes with specific rules applicable to the different categories of investment funds, such as financial investment funds (FIFs – ie, fixed income fund, equity fund, multimarket fund and foreign exchange fund), asset-backed securities funds (FIDCs), private equity funds (FIPs), real estate funds (FIIs), agriculture investment funds (FIAGROs), among others.

Brazilian investment funds are organised as a special condominium, in which financial assets are collectively owned by interest holders, known as "quotas", under a co-ownership framework. The funds can be organised as open-ended condominiums (ie, allowing redemption of quotas during the fund's duration) or closed-ended condominiums (prohibiting redemption of quotas until the end of the fund's term or in the event of early liquidation). Alternative funds are generally set up as closed-ended condominiums.

Pursuant to CVM Resolution 175, all funds are entitled to create different classes of quotas with different economic and political rights, as well as segregation of assets. Subclasses of quotas are also permitted and can be differentiated with respect to:

- target public;
- terms and conditions for investment, amortisation and redemption; and
- administration, management, maximum distribution, entry and exit fees.

Other economic rights and political rights pertaining to subclasses of restricted classes (ie, those exclusively targeted at qualified and professional investors) may be included in the fund's by-laws.

Private Equity Funds (FIPs)

Currently regulated by CVM Resolution 175, FIPs are organised in the form of closed-ended condominiums restricted to qualified investors. FIPs are allowed to invest in shares, debentures, warrants and convertible debt securities issued by listed and unlisted companies. FIPs shall participate in the decision-making process of invested companies and effectively influence the definition of their strategic policies and management (Influence Test). FIPs are classified into the following categories.

- Seed Capital FIPs are allowed to invest in corporations or limited liability companies with gross revenue of up to BRL20 million in the fiscal year prior to the fund's investment.
- Emerging Companies FIPs are allowed to invest in corporations with gross revenue of up to BRL400 million in the fiscal year prior to the fund's investment.
- Infrastructure (FIP-IE) and Intensive Economic Production in Research, Development and Innovation (FIP-PD&I) FIPs are allowed to invest in corporations that develop new infrastructure or intensive economic production in research projects in the energy, transportation, water and sanitation, irrigation sectors, and in other priority areas as determined by the federal government. According to Brazilian regulations, "new projects" are those implemented after 22 January 2007, including expansions of existing or implemented projects or projects in the process of implementation, provided that the investments and results of the expansion are segregated through the establishment of a specific purpose company. Such funds shall have at least five quota holders, none of each being allowed to hold more than 40% of the fund's quotas or to earn income exceeding 40% of its total income.
- Multi-strategy FIPs are the most common form used in the Brazilian market and may invest in different types and sizes of companies. A Multi-Strategy FIP targeted at professional investors may invest up to 100% of its subscribed capital in foreign assets.

FIPs may have classes of quotas with different economic and/or political rights, subject to the applicable regulation. Under CVM Resolution 175, assets can be segregated into different classes of quotas.

Asset-Backed Securities Funds (FIDCs)

FIDCs may be organised as open-ended or closed-ended condominiums. Annex II of CVM Resolution 175 consolidated the rules applicable to FIDCs and FIDC-NP (non-standard asset-backed securities funds) into a single regulation. CVM Resolution 175 allows non-qualified investors (retail) to subscribe/acquire senior quotas of the standard FIDCs, provided that certain requirements are complied with. The subscription of quotas of a FIDC that allows investment in non-standard receivables is restricted to professional investors.

FIDCs may invest in receivables such as credit rights and underlying instruments originating from transactions in the financial, commercial, industrial, real estate, mortgage, leasing and service segments. A FIDC that allows investment in non-standard receivables may also invest in receivables such as litigated claims, government bonds and overdue receivables. FIDCs may have different subclasses of quotas (senior and subordinated). Senior quotas have priority in the amortisation and redemption of quotas, while the other classes of quotas are subordinated to the senior quotas for amortisation and redemption. Per Resolution CVM 175, other economic and political rights may be attributed to FIDCs' subclasses of quotas.

Real Estate Funds (FIIs)

FIIs are organised in the form of closed-ended condominiums and are invested in real estate developments. FIIs may target general investors (retail) or qualified investors.

Quotas of FIIs may be divided into series, with the specific purpose of establishing different dates for the payment of the quotas by the holders of each series of quotas. Quotas targeting qualified investors may be divided into different subclasses with certain limitations. Different classes with different economic and political rights and segregation of assets are also available for FIIs.

Agriculture Investment Funds (FIAGROs)

Introduced by Law No 14,430, FIAGROs are funds that invest in the Brazilian agribusiness sector, which includes rural real estate and other assets related to the agro-industrial productive chain, such as equity interests, financial assets, credit rights, credit instruments, securitisation instruments, quotas of funds, and other securities.

The expansion of agribusiness participation in the capital market was a key focus of the Regulatory Agenda, which also aimed to promote a more sustainable market. In September 2024, the promulgation of CVM Deliberation 214 added Annex Normative VI to CVM Deliberation 175, introducing specific rules for investment funds involved in agro-industrial production chains.

The resolution also allows the acquisition of carbon credits and decarbonisation Credits – CBIOS (a title issued and tradable by biofuel producers) as a new asset class for this fund's portfolio. In this context, the recent Law No 15,042 of 11 December 2024 has created the regulated Brazilian carbon market to encourage the reduction of greenhouse gases and mitigate climate change.

CVM also assigned the fund's manager the responsibility to acquire environmental assets according to reliable certifications, in line with best practices issued by credible third parties, to prevent "carbon washing".

Regarding the limits on the composition and diversification of the asset portfolio, CVM chose to leave it to the discretion of the administrator and the manager of the FIAGRO multimarket fund to define the minimum and maximum investment limits per asset class, as well as the diversification of investment requirements by issuer or debtor, considering the fund's net worth.

If a FIAGRO invests more than 50% of its assets in investment types that are commonly found in other fund categories – such as FIPs, FIDCs, or FIIs – then the regulations that apply to those funds will also apply to the FIAGRO, alongside its specific regulations. In this case, additional limitations must be adhered to.

2.1.2 Common Process for Setting Up Investment Funds

All Brazilian investment funds must be registered with CVM, regardless of whether their quotas are subject to a public or private offer or are open-ended or closed-ended condominiums.

Establishing an alternative investment fund in Brazil requires the fund's administrator and manager to create a constitutive act that approves the formation of the fund and its by-laws. A specific set of documents must be submitted to the CVM for the fund's registration in accordance with the applicable regulations. CVM Resolution 175 establishes that the fund's registration will be automatically granted upon filing the required documents with CVM through CVM's electronic system.

Currently, the fund's enrollment in the Federal Revenue Office taxpayer's register is concurrent with the fund's registration with CVM.

The public placement of quotas requires intermediation by a company pertaining to the so-called Brazilian Securities Distribution System. Such placement must also be registered with CVM for closed-ended investment funds. Such registration shall be effected pursuant to the Securities Law and CVM Resolution 160. Public offerings in Brazil follow the definition found in other jurisdictions – ie, a public offering occurs whenever it is directed to an undetermined group of people. Public offerings are also subject to several other requirements, including:

- publication of a prospectus with respect to the offering of quotas to retail and qualified investors (not applicable to offerings to professional investors);
- publication of offering announcements;
- the payment of a supervisory fee to CVM; and
- adherence to conduct rules under CVM Resolution 160 (such as silence period rules and full and proper disclosure).

Closed-ended investment funds targeting qualified and professional investors undergo an automatic offering registration process with CVM, pursuant to CVM Resolution 160. In such cases, there are no limitations on the maximum number of investors to be assessed. If the quotas of the investment fund, which is subject to an automatic offering registration process with CVM, are subsequently traded to a different category of investors, a lock-up period may apply. For instance, in the case of a fund/class of quotas targeted only at professional investors, no lock-up period will apply if they are traded to other professional investors. However, a 180-day lock-up period will apply if they are traded to qualified investors, and a 12-month lock-up period will apply if they are traded to retail investors).

2.1.3 Limited Liability

Liability is limited to the value of the quotas held by each investor, provided that such limitation is expressly provided in the fund's by-laws. Otherwise, quota holders will be liable for any negative equity of the fund, meaning they could be called to invest more in the fund than their original committed capital.

Due to the provisions in the fund's by-laws, the liability of quota holders is specified in the annexes for each class of quotas. As a result, a single fund can establish various classes of quotas with either unlimited or limited liability.

CVM Resolution 175 also regulates the procedures to be observed by administrators and managers upon the verification that the net equity of a class of quotas with limited liability is negative.

2.1.4 Disclosure Requirements

Pursuant to CVM regulations, investment funds must disclose a variety of information to CVM, the market or the quotaholders.

Information disclosed to quota holders must be comprehensive, equitable and simultaneous. The following materials must be made available on electronic channels and the website of the administrator, the distributor (during distribution) and, if applicable, the managing entity of the organised market where the quotas are traded:

- the updated fund by-laws;
- an updated essential information sheet (*lâmina*), if any;
- the performance history;
- the voting policy; and
- a description of the applicable taxation.

Any marketing materials and other information provided to investors in public offerings must be:

- true, complete, consistent and not misleading;
- written in simple, clear, objective and concise language; and
- useful for investment evaluation.

The information – which must be accompanied by an indication of sources and differentiated from interpretations, opinions, projections and estimates – cannot guarantee or suggest the existence of a guarantee of future results or risk exemption for the investor.

The administrator of the fund is responsible for disclosing the following:

- the value per quota and the net worth of the open-ended funds (daily or at a frequency compatible with the liquidity of the fund);
- a statement containing information on the fund and the quota holder (monthly or at other intervals as provided in the fund's by-laws) to each quota holder, including the balance and value of the quotas at the beginning and the end of the period;
- general information about the fund, including regarding the portfolio; and
- the performance statement of the fund, pursuant to the requirement of CVM regulations.

The administrator shall also submit other documents to CVM and (where applicable) to quota holders and to the organised market where the quotas are admitted for trading, such as daily and monthly newsletters, quarterly and biannual statements regarding the portfolio composition and diversification, the annual accounting statements accompanied by the independent auditor's opinion and a standard form with basic information about the fund, whenever there is an amendment to the by-laws.

The administrator shall also immediately disclose to the quota holders, CVM and the organised market where the quotas are admitted for trading any relevant act or fact that occurred or is related to the functioning of the fund or the assets that are part of the portfolio, which might reasonably influence the value of the quotas or the decision of the investors to acquire, sell or keep such quotas.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

The following investors have been active in alternative investments:

- institutional investors, notably development banks, other financial institutions and pension funds;
- foreign investors, including sovereign funds and private equity funds;
- family offices; and
- high net worth individuals (qualified or professional investors).

2.2.2 Legal Structures Used by Fund Managers

Please see **2.1.1 Fund Structures** for the legal structures typically used by alternative fund managers in Brazil.

According to Brazilian law, investment funds shall generally have a fiduciary administrator (principal fund "gatekeeper") and an asset manager (responsible for the investment and divestment decisions, subject to the limitations set out in the fund's by-laws), both of which are duly authorised by CVM to provide securities portfolio management services.

The fiduciary administrator shall be a legal entity, while asset managers may be either an individual or a legal entity (for FIPs, the manager shall be a legal entity in any event). In addition, entities may be registered as "full administrators", meaning they can act as both fiduciary administrators and asset managers, provided they comply with the Chinese wall requirements.

CVM Resolution No 21 of 25 February 2021 set forth the minimum criteria applicable to fiduciary administrators and asset managers, including that they must be domiciled or have their headquarters in Brazil.

FIIs may be administered by commercial banks, multiple banks with investment portfolios or real estate loan portfolios, investment banks, brokerage companies or securities dealerships, real estate credit companies, savings banks or mortgage companies.

2.2.3 Restrictions on Investors

Investors are divided into three categories in Brazil:

- professional investors;
- qualified investors; and
- non-qualified investors.

According to current CVM regulation, FIPs and FIDCs are restricted to qualified investors, while FIIs can also be marketed to non-qualified investors (ie, retail investors). As mentioned in **2.1.1 Fund Structures**, CVM Resolution 175 allows senior quotas of FIDCs to be targeted at non-qualified investors.

CVM Resolution No 30/2021 set forth the criteria for qualified investors (including individuals or legal entities that hold financial investments in an aggregate amount exceeding BRL1 million) and professional investors (including individuals or legal entities that hold financial investments in an aggregate amount exceeding BRL10 million and non-resident investors).

Non-professional or non-qualified investors are considered retail investors.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

For more information on the regulatory regime applying to alternative funds in Brazil, please see **2.1.1 Fund Structures.**

ANBIMA establishes rules for the market for enforcement and control, as well as codes of best practice for its members, which include asset managers, banks, brokers, securities dealers and investment advisers. It monitors the application of such codes and issues penalties for non-compliance.

Brazilian regulations set forth rules regarding the composition of the portfolio of alternative funds and certain limitations, as summarised below.

FIPs

A FIP must maintain at least 90% of its net assets invested in securities (90% Rule), which will not apply during the term set forth in the regulations for the FIP to consummate an investment after a capital call. Considering the 90% Rule, the regulations set forth that amounts may be added to the net assets invested in securities, such as amounts for the payment of the FIP's expenses (limited to 5% of the committed capital), funds deriving from a divestment (subject to certain conditions), etc.

If the issuer of the securities targeted by the FIP is a privately held company, certain governance requirements must be observed by such issuer.

There is no maximum or minimum number of companies in which a FIP may invest, nor is there a maximum or minimum percentage of shares (ie, equity interest) that a FIP must hold in an invested company, provided in any case that the Influence Test is met and subject to certain concentration limits.

FIPs may invest up to:

- 33% of their subscribed capital in foreign assets (securities) unless the fund is targeted at professional investors, in which case the FIP may invest up to 100% of its subscribed capital in foreign assets; and
- 33% of their subscribed capital in non-convertible debentures or other non-convertible debt instruments, except for FIP-IEs, which may invest up to 100% in such debt instruments.

FIPs may invest in quotas of other FIPs or equity funds. FIPs may not invest in credit rights – except those issued by fund-invested companies.

FIDCs

FIDCs may acquire credit rights and other assets of the same debtor or a co-obligation of the same debtor within the limit of 20% of its net equity. This limit may not apply if the fund targets professional investors. The limit may also be increased if certain requirements are met (eg, the debtor is a publicly-held company or has financial statements audited by an independent auditor registered with CVM). The fund may acquire credit rights originated or assigned by the administrator, manager, custodian or specialised consultant, or parties related to them in certain situations, namely:

- when the manager, registering entity and custodian of the credit rights are not related parties between themselves, and, cumulatively, the registrar and the custodian are not parties related to the originator or assignor; and
- in the case of classes of quotas intended exclusively for professional investors.

Other rules regarding the composition of the portfolio and limitation on investment by the issuer and by type of investment can also be included in the fund's by-laws.

FIIs

The properties, assets, and use rights to be acquired by FIIs must be subject to prior evaluation by the administrator, the manager, or an independent third party and subject to the requirements set out in the regulations. FIIs that invest predominantly in securities must respect the limits of application by the issuer and by the type of financial assets established in the general rules on investment funds. Such limits do not apply to investments by FIIs in quotas of FIPs, FIIs and certificates of real estate receivables and quotas of FIDCs.

FIIs can maintain a portion of their assets permanently invested in investment funds or fixed-income securities, public or private, to meet liquidity needs.

2.3.2 Requirements for Non-Local Service Providers

The main service providers of Brazilian investment funds, such as the fiduciary administrators, asset managers, custodians and bookkeepers, have to be established in Brazil and shall be duly authorised by CVM (with the exceptions applicable to FIIs) or by a recognised local authority.

Administrators and portfolio asset managers must comply with the requirements of CVM Resolution 21, as explained in **2.2.2 Legal Structures Used by Fund Managers**.

2.3.3 Local Regulatory Requirements for Non-Local Managers

Please see **2.3.2 Requirements for Non-local Service Providers**.

2.3.4 Regulatory Approval Process

Please see **2.1.2 Common Process for Setting Up Investment Funds**.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

Conduct rules outlined in CVM Resolution 160, specifically the silence period regulations, stipulate that the participants in the offering are explicitly prohibited from publicising the public offering or making statements regarding the fund during the following periods:

- from the moment the public offer is approved through a deliberative act or on the 30 days prior to the filing of the offer registration request with the CVM, whichever is earlier; and
- ending on the date of announcement of the closing of the public offering (quiet period).

2.3.6 Rules Concerning Marketing of Alternative Funds

The marketing and distribution of quotas of investment funds in Brazil shall be made by members of the Distribution System.

Under the applicable regulation, the asset manager may act as the distributor of quotas of the funds under its investment management or administration, subject to the adoption of some procedures and policies applicable to distributors.

All marketing materials of investment funds must be clear and concise, contain specific disclaimers and information regarding the fund's by-laws, and alert the investors of the investment risks. Conduct rules set forth in CVM Resolution 160 also apply (such as silence period rules, full and proper disclosure, etc).

In the case of open-ended investment funds targeted at retail investors, the administrator must prepare an essential information sheet, including information such as target investors, the fund's purpose, the investment policy, risks, profitability, etc.

2.3.7 Marketing of Alternative Funds

Please see **2.2.3 Restrictions on Investors** for more information on the investors to whom alternative funds can be marketed in Brazil.

2.3.8 Marketing Authorisation/Notification Process

Notification is required only after the use of marketing material as permitted under CVM Resolution 160, which shall be sent to CVM within one business day after its use.

2.3.9 Post-Marketing Ongoing Requirements

During the period between the beginning of the quiet period (as indicated in **2.3.5 Rules Concerning Pre-marketing of Alternative Funds**) and the date of disclosure of the notice to the market, the offer participants must limit the disclosure and use of information regarding the public offer strictly to the purposes related to the preparation of the public offering, warning recipients about the reserved nature of the information transmitted.

After the beginning of the market offering period, the offering participants may widely publicise the public offering, provided that the conditions set forth in CVM Resolution 160 are observed, including by means of disseminating:

- the prospectus and offer sheet;
- material of an explanatory and educational nature that contains useful and relevant aspects;
- marketing material;
- presentations to investors, including supporting documents for such presentations; and
- media interviews.

The permitted communications must:

- be consistent with the content of the prospectus and the issuer's periodic information required by the legislation in force;
- use calm and moderate language;
- observe the principles of quality, transparency and equity of access to information; and
- refrain from:
  (a) using language that omits or does not adequately reflect the existence of risks;
  (b) containing statements that remove the responsibility of the offeror and the institutions participating in the distribution consortium regarding the information provided;
  (c) stating that it is not a public offer;
  (d) stating that the information contained in the communication is confidential;
  (e) containing language of a contractual nature that implies a perception of tacit consent to a reservation or placing an order; and

(f) using information that is false, inaccurate or misleading to the investor.

2.3.10 Investor Protection Rules

Please see **2.2.3 Restrictions on Investors** for more information on the restrictions relating to certain categories of investors in certain types of alternative investment funds.

The administrator and the manager of an investment fund have fiduciary duties towards the fund and its quota holders and shall be liable for any damages caused to the quota holders in case of non-compliance with the fund's by-laws or the applicable laws and regulations.

CVM may apply penalties to service providers for any violation of the fund's by-laws or the applicable laws and regulations, including fines, suspension of authorisation or registration for the exercise of the administration and/or management activities or temporary disqualification to carry out such activities, up to a maximum of 20 years.

2.3.11 Approach of the Regulator

CVM typically responds to day-to-day inquiries via email within a reasonable timeframe. They also welcome virtual or in-person meetings, which can be requested online through their website. For more complex questions, it is recommended to submit a formal consultation to CVM; however, this may result in a longer response time. All registration processes are completed electronically through the CVM website.

2.4 Operational Requirements

Each alternative fund is allowed to invest in certain types of assets, as provided by its specific regulation. For types of investments and the applicable regulation for each alternative fund, please see **2.1.1 Fund Structures** and **2.3.1 Regulatory Regime**.

Pursuant to Brazilian regulations, investment funds must engage a custodian duly authorised by CVM, which will be responsible for managing the bookkeeping of the investment fund's assets. For FIIs, the custody service is not required for financial assets that represent up to 5% of the fund's net equity, provided that such assets are admitted for trading on a stock exchange or organised over-the-counter market or are registered in a registration or financial settlement system authorised by the Central Bank of Brazil or CVM.

The main regulations regarding risk, borrowing restrictions and the valuation and pricing of the assets held by investment funds are set up by CVM Resolution 175, as described in **3.4 Operational Requirements**.

In addition to the general rules, Normative Annex IV of CVM Resolution 175 provides that FIPs that obtain direct financial support from development agencies are authorised to contract loans directly from such development agencies, limited to an amount corresponding to 30% of the FIP's assets. In addition, the FIP's administrator and asset manager may contract a loan on behalf of the fund only in cases authorised by CVM (in practice, a consultation should be submitted to CVM requesting authorisation for such borrowing) or cover the default of quota holders who have not paid their subscribed quotas. The last case will also be applied to classes of quotas destined for qualified or professional investors of all other categories of funds as set forth in CVM Resolution 175.

As for FIDCs, the administrator may not currently borrow or grant loans on behalf of the fund, which only allows the granting of loans and the assumption of debts because of transactions carried out in the derivative market.

FIIs are not currently allowed to borrow or grant loans. They may borrow their equities and securities, provided that such loans are processed exclusively through services authorised by the Brazilian Central Bank or CVM or are to provide guarantees for their own operations.

Also, for each type of alternative fund, CVM regulates the accounting standards for the recognition, classification and measurement of assets and liabilities, as well as those for valuation, pricing and revenue recognition, the appropriation of expenses and the disclosure of information in the financial statements for each investment fund, which are expressly provided by the following:

- CVM Instruction No 579 of 30 August 2016 for FIPs;
- CVM Instruction No 489 of 14 January 2011 for FIDCs; and
- CVM Instruction No 516 of 29 December 2011 for FIIs.

According to Brazilian law, insider dealing and market abuse are illegal activities subject to administrative, civil, and criminal sanctions. CVM penalties for such activities include warnings, fines, suspension, or even prohibition from trading in the capital markets.

2.5 Fund Finance

Please see **2.4 Operational Requirements**.

2.6 Tax Regime

An investment fund in Brazil does not have a formal corporate existence and is classified solely as a flow-through entity. As such, it is not considered a legal entity for tax purposes and is not regarded as a taxpayer from a legal standpoint. Investment funds benefit from a special income tax treatment that typically allows for a deferral of taxes on any gains accrued by the fund's portfolio.

In this context, an investment fund can invest in different assets, be remunerated by such investment, and/or sell its investments, and none of those gains will be taxable at the fund level. Such gains will only be taxed (if ever) at the level of the investors whenever some specific events are verified (eg, amortisation of quotas, the redemption of quotas or liquidation of the fund).

FIPs

Pursuant to Law No 11,312/2006, gains and earnings obtained by the investors of a FIP whose portfolio is compliant with CVM regulations are generally subject to withholding income tax (WHT) at a 15% rate.

Nonetheless, Law 11,312 establishes a specific tax treatment applicable to foreign investors who invest in an FIP by means of the mechanisms provided for by Resolution 13, jointly issued on 3 December 2024 by the National Monetary Council and the Central Bank of Brazil, provided certain requirements are met. Under this specific tax treatment – and provided all legal requirements are met – gains and earnings recognised by foreign investors that are not resident nor domiciled in low-tax jurisdictions as a result of the amortisation, redemption or sale of the FIP's quotas are subject to WHT at a 0% rate.

Foreign investors of an FIP that are residents or domiciled in low-tax jurisdictions (as per the concept provided by Brazilian tax law) are not entitled to the special tax treatment set out above, thus being subject to WHT at a 15% upon gains and earnings deriving from the investment in the fund.

The legal requirements to avail of the specific tax treatment afforded to foreign investors have been significantly changed by Law 14,711/2023, enacted on 30 October 2023. The legal requirements originally set forth by Law 11,312 and those set forth by Law 14,711/2023 for applying the specific tax regime are as follows.

- Residence of investors:
  - (a) Original legal requirement – Law 11,312: quota holders domiciled or resident in a low tax jurisdiction, as defined by Brazilian legislation, did not benefit from the special regime.
  - (b) New requirement – Law 14,711: quota holders that are domiciled or residents in a low-tax jurisdiction still cannot benefit from the special regime (exception made to sovereign funds).
- FIP portfolio:
  - (a) Original legal requirement – Law 11,312: at least 67% of the FIP's portfolio should be represented by shares of corporations (SA), convertible debentures or warrants, and the FIP could not have, at any time, debt bonds equal to or higher than 5% of its net assets (not including public bonds or convertible securities).
  - (b) New requirement – Law 14,711: a FIP's portfolio shall observe CVM regulations.
- 40% Test:
  - (a) Original legal requirement – Law 11,312: the foreign investor should not hold, directly or via related parties, more than 40% of the quotas of the FIP or be entitled to receive more than 40% of the FIP's earnings. Such requirements were cumulative with the 90% Rule. If those requirements were not met, gains and earnings received by foreign investors of the FIP were subject to WHT at a 15% rate.
  - (b) New requirement – Law 14,711: the 40% Test was revoked. The foreign investor of the FIP can now hold any percentage of the fund's quotas or be entitled to receive any percentage of the FIP's earnings to benefit from the regime, provided all the other requirements are met.
- Investment Entity:
  - (a) Original legal requirements – Law 11,312: There was no provision requiring the FIP to qualify as an investment entity for the foreign investors of the FIP to benefit from the special regime.
  - (b) New requirements – Law 14,711: The special regime only applies to foreign investors of FIPs that qualify as an investment entity, based on the rules defined by the National Monetary Council.

Finally, Law 14,754/2023 modified the tax regime applicable to funds in general and introduced the come-quotas taxation for closed funds – in accordance with which earnings arising from the fund's portfolio are to be subjected to WHT in May and November of each calendar year (regardless of any effective distribution to the quota holders). There are, however, certain exceptions, amongst which: FIPs that qualify as investment entities and comply with the portfolio composition requirements established by CVM are not subject to such regime.

FIP-IEs

Law No 11,478/2007 provides that any income (including capital gains) received by Brazilian individuals from FIP-IEs benefits from 0% WHT, provided that the general legal requirements for 0% benefits are met (ie, the requirements applicable to FIP-IEs – see **2.1.1 Fund Structures**).

Legal entity quota holders of a FIP-IE are subject to WHT at a rate of 15% upon the income earned upon the redemption and amortisation of quotas and in the case of liquidation of the fund or the sale of the quotas. For foreign investors, the same specific tax treatment afforded to FIPs applies to FIP-IEs. The original tax treatment applicable to foreign investors in FIP-IEs was also changed by Law 14,711.

FIDCs

Gains derived by quota holders of an FIDC upon distributions by the fund are subject to WHT.

Law 14,754/2023 established the following:

- If the FIDC has a portfolio composed of at least 67% of credit rights ("Diversification Rule"), gains arising from the investment in the FIDC shall be subject to WHT at a general 15% rate;
- If the FIDC adheres to the Diversification Rule and qualifies as an investment entity according to the regulations set by the National Monetary Council, its investors will not be subject to "come-quotas" taxation. In this case, the 15% WHT will only be applicable upon the actual distribution of income, the amortisation, or the redemption of quotas.

On the other hand, if the FIDC follows the Diversification Rule but does not qualify as an investment entity, different rules apply. In this scenario, quota holders will face mandatory "come-quotas" taxation, and a 15% WHT will be imposed in May and November of each year on the income and gains accrued up to those dates. This tax will also apply upon the investor's actual redemption or amortisation of the quotas, whichever comes first.

If the Diversification Rules is not met, then the general rule is that gains arising from the investment in the FIDC shall be subject to WHT at regressive rates from 22.5% to 15%, depending on whether the fund is qualified as a long-term investment (if the FIDC portfolio has a term of more than 365 days) or a short-term investment (if the FIDC portfolio has a term of less than 365 days), as follows.

- Long-term investment:
  (a) 22.5% rate – investments term up to 180 days;
  (b) 20% rate – investments term from 181 days up to 360 days;
  (c) 17.5% rate – investments term from 361 days up to 720 days; and
  (d) 15% rate – investments term over 720 days.
- Short-term investment:
  (a) 22.5% rate – investments term up to 180 days; and
  (b) 20% rate – investments term over 180 days.

As the FIDC that does not comply with the Diversification Rule is not subject to the specific tax treatment provided for by Law N. 14,754/2023, it is subject to the general rule of "come-quotas" provided by said legislation, which applies as follows:

- Long-term investment: mandatory imposition of "come-quotas" and subjection of the accrued earnings of the investor to the WHT at a 15% rate in May and November of each year or at the date of the effective redemption or amortisation of the quotas – whichever occurs first.
- Short-term investment: mandatory imposition of "come-quotas" and subjection of the accrued earnings of the investor to the WHT

at a 20% rate in May and November of each year or at the date of the effective redemption or amortisation of the quotas – whichever occurs first.

In respect of non-resident investors, the WHT treatment upon income and gains arising from the investment in FIDCs shall vary as follows:

- non-resident investor that is not located in a low tax jurisdiction: WHT at a flat 15% rate, without "come-quotas" taxation;
- non-resident investors located in low-tax jurisdictions: WHT at a flat 15% rate, with "come-quotas" taxation.

Legal entities that invest in FIDC should consider WHT as an anticipation to corporate income tax (IRPJ), whilst the WHT levied upon the income and the gains derived by individuals and non-resident investors of the FIDC, WHT is definitive.

In addition to WHT for the investor, for open-ended funds, there is also a tax on financial transactions (IOF/*Títulos*) if the redemption of the fund's quotas occurs before the 30th day of investment on a regressive rate basis.

FIIs

As per Law No 8,668/93, the FII must distribute its results to the quota holders twice a year.

Taxation of FII's accrued gains only occurs at the investor's level, and the respective treatment will depend on the investor's location. There is one exception to this rule: Law No 8,668/93 establishes that FIIs investing in any real estate enterprise that has a quota holder holding (individually or jointly with an affiliate) more than 25% of the quotas of the FII as a developer, constructor or partner will be taxed as a legal entity.

The gains upon distributions by the FII and the gains derived from the sale of the FII's quotas are generally subject to WHT at a 20% rate. Gains upon distributions made to and gains derived from the sale of the quotas by beneficiaries not located in low-tax jurisdictions that invest in Brazil via the mechanics of Resolution N. 13/2024 are subject to WHT at a 15% rate.

However, if the FII's quotas are publicly traded and the quotas are sold within the stock exchange, gains earned by foreign investors not located in low-tax jurisdictions would be subject to WHT at a rate of 0%. Applying the 0% WHT to a sale performed within an over-the-counter market is controversial.

In respect of Brazilian individuals, investor's gains are exempt when the quota holder holds less than 10% of the fund's quotas or is entitled to receive less than 10% of the fund's total income, provided that the FII has at least 100 quota holders and its quotas are traded exclusively on the stock exchange or organised over-the-counter market. Furthermore, Law 14,754 has amended the provisions of Law N. 11,033/2004 to establish that this tax exemption does not apply to a group of individuals that qualify as related parties if they jointly own 30% or more of the FII's quotas or if they are entitled to receive earnings that represent more than 30% of the total gains of the FII.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Brazilian retail funds are also organised as condominiums (pool of assets) and can be organised as closed-ended or open-ended funds, as mentioned in **2.1.1 Fund Structures**.

Retail funds are regulated mainly by CVM Resolution 175 Normative Annex I of CVM Resolution 175 (called FIFs) and are classified as follows.

- Fixed Income Fund: the main risk factor for the portfolio of such fund must be the variation of the interest rate, the price index, or both. Such funds must have at least 80% of their portfolio in assets directly related, or synthesised via derivatives, to the risk factor that names this class of funds. In this category of funds, there is also the incentivised infrastructure fund aimed at investing in infrastructure assets with an incentivised tax treatment pursuant to Federal Law No 12,431/2011.
- Equity Fund: the main risk factor for the portfolio of such fund must be the variation of the prices of shares admitted for trading in the organised market. At least 67% of the equity fund's net worth must be represented by:
  (a) shares admitted for trading in the organised market;
  (b) warrants or subscription receipts and depositary certificates of shares admitted for trading in the organised market;
  (c) equity fund quotas and quotas of share-based index funds; and
  (d) Brazilian Depositary Receipts (BDR) classified as level II and III (BDR-Shares and BDR-ETF Shares).
- Foreign Exchange Fund: the main portfolio risk factor for such a fund must be the variation of foreign currency prices or the variation of the exchange rate coupon. Such funds must have at least 80% of their portfolio assets directly related, or synthesised via derivatives, to the risk factor that names this category of funds.
- Multimarket Fund: such funds must have investment policies involving several risk factors without the commitment to concentrate on any particular factor.

In addition, Normative Annex V of CVM Resolution 175 regulates exchange-traded funds (ETFs), which are retail funds formed as open-ended funds. ETFs' quotas are required to be admitted for trading in stock exchanges or organised markets. Brazilian-formed ETFs may be backed by variable-income and fixed indexes, and at least 95% of their net equity must be invested in:

- financial assets composing the index;
- liquidity positions in future contracts, which shall be traded on a commodities and futures exchange and settled in clearing and settlement chambers and service providers that assume the position of central counterparty; and
- quotas of other index funds that aim to reflect the variations and profitability of the investor ETF's benchmark index.

3.1.2 Common Process for Setting Up Investment Funds

The process for setting up the common structures used for retail funds in Brazil is similar to the process for alternative investment funds; please see **2.1.2 Common Process for Setting Up Investment Funds**.

Retail funds are automatically registered with CVM when the requested set of documents is filed.

3.1.3 Limited Liability

The rules regarding the limited liability of retail fund investors are the same as for alternative investment fund investors; please see **2.1.3 Limited Liability**.

3.1.4 Disclosure Requirements

The disclosure requirements for retail funds are the same as provided for alternative investment funds; please see **2.1.4 Disclosure Requirements**.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

Please see **1.1 State of the Market** and **2.2.1 Types of Investors in Alternative Funds**.

3.2.2 Legal Structures Used by Fund Managers

Please see **3.1.1 Fund Structures** for more information on the legal structures used by retail fund managers in Brazil.

3.2.3 Restrictions on Investors

There is no legal requirement regarding the type of investor to which retail funds can be marketed in Brazil.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

Please see **3.1.1 Fund Structures** for more information on the regulatory regime applicable to retail funds.

Limitations on the Composition of the Portfolio

A retail fund must invest its equity in financial assets that are registered in a registration system or that are the object of custody or a central deposit, in all cases with institutions duly authorised to perform such activities by the Central Bank of Brazil or by CVM. This does not apply to open-ended investment fund quotas duly registered with CVM. A retail fund may not invest in quotas of funds that hold an interest in such retail fund.

Foreign assets

FIFs are subject to the following concentration limits when investing in financial assets abroad:

- there are no limits for:
  (a) funds (or class of quota pursuant to CVM Resolution 175) classified as "Fixed Income – External Debt";
  (b) funds (or class of quota pursuant to CVM Resolution 175) exclusively targeted at professional investors.
- up to 40% of net equity for funds exclusively targeted at qualified investors;
- up to 20% of net equity for funds targeted at the general public; and
- investment is prohibited for fixed-income funds classified as "simple" (ie, those with 95% of the net equity invested in federal public debt securities, fixed-income securities issued by financial institutions or operations backed by federal public debt securities or by securities issued by institutions authorised).

Under CVM Resolution 175, the limits applicable to classes of quotas targeted at qualified investors may be exceeded if certain requirements are met.

Limits per issuer

The concentration limits per issuer for FIFs are as follows, according to the general rules:

- up to 20% of the fund's net equity when the issuer is a financial institution authorised to operate by the Central Bank of Brazil;
- up to 10% of the fund's net equity when the issuer is a publicly held company;
- up to 5% of the fund's net equity when the issuer is a natural person or a legal entity under private law that is not a publicly held company or financial institution authorised to operate by the Central Bank of Brazil; and
- no limits when the issuer is the Federal Union, an investment fund or when the investment policy provides for the acquisition of assets of a single securities issuance.

CVM Resolution 175 also sets forth that there will be no limits per issuer when the issuer is an investment fund, and the investment policy provides for the acquisition of fungible assets from a single issue of securities.

Limits by type of financial asset

According to the general rules, the concentration limits per type of financial asset for retail funds are as follows.

- Up to 20% of the fund's net equity for the following assets:
  - (a) FIF's quotas targeted at qualified investors, of which 5% may be directed at FIFs' quotas targeted exclusively at professional investors;
  - (b) quotas of FII;
  - (c) quotas of FIDC, of which 5% may be directed at FIDCs investing in non-standard credit rights;
  - (d) Certificates of Real Estate Receivables (CRI); and
  - (e) securities issued by privately held companies.
- Up to 15% of the fund's net equity for the following assets:
  - (a) FIP's quotas;
  - (b) quotas of agro-industrial investment funds (FIAGRO);
- Up to 10% of the fund's net equity for the following assets:
  - (a) collective investment bonds and contracts;
  - (b) crypto-assets, carbon credits and CBIO;
  - (c) securities issued through electronic participatory investment platforms, as long as they are subject to bookkeeping carried out by a bookkeeper authorised by the CVM; and
  - (d) other financial assets not provided for above.

There is no concentration limit per type of financial asset for investment in:

- federal public securities and repo operations backed by these securities;
- gold, provided it is negotiated in an organised market;
- the issuance or co-obligation of securities of a financial institution authorised to operate by the Central Bank of Brazil;
- promissory notes, debentures and shares, provided publicly held companies have issued them and are subject to a public offering;
- FIFs targeted at the public in general;
- ETFs, BDR-shares, BDR-corporate debt and BDR-ETF;
- derivative contracts, unless referenced to the assets listed above; and
- assets, perfectly fungible from a single issue of securities, provided that this specific application constitutes the investment policy of the class and the assets have been issued by publicly held companies and are the subject of a public offering.

FIFs targeted at professional investors are exempted from the concentration limits. FIFs targeted at qualified investors may increase the percentage of the concentration limits.

For ETFs that seek to reflect the variations and profitability of fixed-income indexes (ie, fixed-income ETFs), financial assets that are not part of the benchmark index but are of the same nature as those with different issuances will be admitted, limited to 20% of the ETF's net equity.

3.3.2 Requirements for Non-Local Service Providers

Please see **2.3.2 Requirements for Non-local Service Providers**.

3.3.3 Local Regulatory Requirements for Non-Local Managers

Please see **2.3.2 Requirements for Non-local Service Providers**.

3.3.4 Regulatory Approval Process

Please see **3.1.2 Common Process for Setting Up Investment Funds**.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Please see **2.3.5 Rules Concerning Pre-marketing of Alternative Funds** for more information.

3.3.6 Rules Concerning Marketing of Retail Funds

Please see **2.3.6 Rules Concerning Marketing of Alternative Funds**.

3.3.7 Marketing of Retail Funds

Please see **3.2.3 Restrictions on Investors**.

3.3.8 Marketing Authorisation/Notification Process

Please see **2.3.8 Marketing Authorisation/Notification Process** for more information.

3.3.9 Post-Marketing Ongoing Requirements

Please see **2.3.9 Post-marketing Ongoing Requirements** for more information.

3.3.10 Investor Protection Rules

Please see **3.2.3 Restrictions on Investors** and **2.3.10 Investor Protection Rules**.

3.3.11 Approach of the Regulator

Please see **2.3.11 Approach of the Regulator**.

3.4 Operational Requirements

As described in **3.1.1 Fund Structures**, each retail fund is allowed to invest in certain types of assets.

Like alternative funds, retail funds must also engage a custodian, which shall be an entity duly authorised by CVM.

Upon becoming quota holders, all investors must confirm, through the formalisation of an adhesion and risk acknowledgement term, that they had access to the entire content of the by-laws and the essential information sheet, if applicable, and that they are aware of the risk factors related to the fund.

The administrator and the asset manager are not allowed to borrow or grant loans on behalf of the fund, except in cases authorised by CVM or specific cases set forth in the regulations. Investment funds may use their assets to provide guarantees for their own operations, as well as lend and borrow financial assets, provided such loan operations are processed exclusively through services authorised by the Brazilian Central Bank or CVM.

The fiduciary administrator is required to have a manual regarding its valuation practices for both liquid and illiquid assets available on its website. Also, all investment funds must follow international accounting standards.

ETFs may carry out lending transactions with respect to the securities of the portfolio in the manner regulated by CVM and in accordance with the limits and conditions set forth in the ETF’s by-laws.

Resolution CVM 175 sets forth the possibility of the manager/administrator borrowing to cover for negative equity of a class of quotas.

3.5 Fund Finance

Please see **3.4 Operational Requirements**.

Contributed by: Guilherme Bueno Malouf, Luciana Costa Engelberg, Bruna Marrara and Thales Saito,
Machado Meyer Advogados

3.6 Tax Regime

As investment funds do not have legal personality and are not subject to taxation on income and gains derived from their portfolio, no taxes are due at the fund level. Taxation shall occur in relation to (and at the level of) the investors only and not to the fund itself.

The definition of the tax treatment applicable to the quota holder is contingent upon the verification of the nature of the investment fund (eg, ETF, FIP, FIF), as well as of the characteristics of the investor itself (ie, Brazilian individual or legal entity; if the foreigner is either resident or domiciled in a low tax jurisdiction or not, etc).

Generally speaking, the tax treatment applicable to the earnings arising from the redemption or amortisation of quotas of Brazilian investment funds are subject to WHT at regressive rates, depending on whether the fund is qualified as a long-term investment (if the fund portfolio has a term of more than 365 days) or a short-term investment (if the fund portfolio has a term of less than 365 days), as follows:

- Long-term investment:
  (a) 22.5% rate – investment term of up to 180 days;
  (b) 20% rate – from 181 days up to 360 days;
  (c) 17.5% rate – from 361 days up to 720 days; and
  (d) 15% rate – investment term over 720 days.
- Short-term investment:
  (a) 22.5% rate – investments term of use up to 180 days; and
  (b) 20% rate – investment term over 180 days.

In respect of such general tax treatment, Law No 14,754/2023 introduced the “come-quotas” taxation to be in force on 1 January 2024 to both closed-ended and open-ended funds. The general rule of “come-quotas” provided by said legislation applies as follows:

- Long-term investment: mandatory imposition of “come-quotas” and subjection of the accrued earnings of the investor to the WHT at a 15% rate in May and November of each year or at the date of the effective redemption or amortisation of the quotas – whichever occurs first.
- Short-term investment: mandatory imposition of “come-quotas” and subjection of the accrued earnings of the investor to the WHT at a 20% rate in May and November of each year or at the date of the effective redemption or amortisation of the quotas – whichever occurs first.

Legal entities that invest in funds should consider WHT as an anticipation to corporate income tax (IRPJ), whilst the WHT levied upon the income and the gains derived by individuals and non-resident investors of the fund, WHT is definitive.

In addition to WHT for the investor, for open-ended funds, there is also a tax on financial transactions (IOF/Títulos) if the redemption of the fund’s quotas occurs before the 30th day of investment on a regressive rate basis.

Specific considerations may apply in connection with specific types of funds, such as ETFs, as outlined below.

ETFs

Brazilian law distinguishes variable income ETFs from fixed income ETFs, as follows:

- a fixed-income ETF is qualified as such for tax purposes if it invests at least 75% of its net worth in financial assets that are covered or referenced by the underlying fixed-income index; and
- a variable income ETF is qualified as such for tax purposes if its portfolio comprises stocks also covered by the underlying index.

As per Law N. 14,754/2023, the following tax treatment applies to variable income ETFs that comply with the portfolio allocation, classification and reclassification requirements set out in the regulations of the CVM and have quotas that are effectively traded on a stock exchange or organised over-the-counter market in Brazil: gains arising from the investment in the ETF shall be subject to WHT at a general 15% rate.

If the ETF is deemed an investment entity in accordance with the rules of the National Monetary Council, then its investors shall not be subject to the come-quotas taxation, and the 15% WHT shall only be due upon the date of effective distribution of income, amortisation or redemption of quotas.

Conversely, if the ETF does not qualify as an investment entity, the following rules will apply: quota holders will be subject to mandatory come-quotas taxation, and a 15% withholding tax will be imposed in May and November of each year on the income and gains accrued up to those dates. This tax will also apply upon the investor's actual redemption or amortisation of the quotas, whichever occurs first.

Variable income ETFs that do not comply with the portfolio allocation, classification and reclassification requirements provided for by the CVM are subject to the general rule of "come-quotas" provided by Law N. 14,754/2023, which applies as follows:

- Long-term investment: mandatory imposition of "come-quotas" and subjection of the accrued earnings of the investor to the WHT at a 15% rate in May and November of each year or at the date of the effective redemption or amortisation of the quotas – whichever occurs first.
- Short-term investment: mandatory imposition of "come-quotas" and subjection of the accrued earnings of the investor to the WHT at a 20% rate in May and November of each year or at the date of the effective redemption or amortisation of the quotas – whichever occurs first.

As expressly provided by Law N. 14,754/2023, fixed-income ETFs are not subject to the overall "come-quotas" regime such legislation provides. The gains and income arising from the investment in a fixed-income ETF are taxed at the following rates upon the effective redemption or amortisation of the quotas:

- 25% rate – investment term of up to 180 days;
- 20% rate – investment term from 181 days up to 720 days; and
- 15% rate – investment term of over 720 days.

Gains on the disposal or redemption of quotas of a fixed-income ETF are calculated using the same rates as applied to distributions.

Contributed by: Guilherme Bueno Malouf, Luciana Costa Engelberg, Bruna Marrara and Thales Saito,
Machado Meyer Advogados

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Regulatory

CVM Resolution 175 came into force on 2 October 2023 (except for some specific rules that apply later) and significantly changed the regulatory framework applicable to investment funds in Brazil.

Tax

Law 14,754/2023 substantially modified the overall tax treatment applicable to investment funds in Brazil, and the main changes provided for by such legislation are described below:

- As of 1 January 2024, earnings derived by investment funds, including closed-end funds, are subject to the come-quotas taxation.
- Earnings and gains of certain funds such as FIPs, FIDCs, Stock Funds (FIA) and ETFs are not subject to such regime if they (i) qualify as an investment entity on the terms defined by the National Monetary Council, and (ii) comply with the following requirements:
  (a) FIPs shall comply with the portfolio composition requirements established by CVM;
  (b) FIDCs shall have a portfolio composed of at least 67% of credit rights and comply with the portfolio composition requirement within 180 days from the first subscription of quotas.
  (c) FIAs shall have a portfolio composed of at least 67% of variable-income financial assets (eg, shares, subscription certificates, share deposit certificates, BDRs, etc), regardless of whether they are qualified as investment entities.
  (d) ETFs shall comply with the portfolio composition, classification and reclassification established by CVM and shall have quotas listed on a stock exchange or organised over-the-counter market (an exception made to Fixed Income ETFs).

If the funds do not comply with such requirements, they will be subject to the come-quotas taxation.

Funds of funds

Funds that invest 95% of their net assets in FIPs, ETFs (Variable Income) and FIDCs (classified as investment entities), FIAs, FIIs, FIAGRO, FIP-IE, FIP-PD&I and Infrastructure Investment Funds are not subject to the come-quotas taxation.

Foreign quota holders of Brazilian investment funds are not subject to the come-quotas taxation if they are not domiciled in a low-tax jurisdiction.

Different quota classes

In cases in which the investment fund has different quota classes, with different rights and obligations, and segregated net equity of the fund for each class, each quota class will be considered a fund for tax purposes.

The transference of quotas among different subclasses within the same class of quotas is not considered a taxation event for purposes of the WHT imposition if there is no change in quota ownership and no distribution is to quota holders.

Funds reorganisations

Law 14,754/2023 introduced the tax treatment that should be observed in mergers, spin-offs and transformations of investment funds.

CAYMAN ISLANDS

Cuba
Cayman Islands
Jamaica

Law and Practice

Contributed by:
Christie Walton, Patrick Rosenfeld and Philip Dickinson
Maples Group

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Maples Group advises global financial, institutional, business and private clients on the laws of the British Virgin Islands, the Cayman Islands, Ireland, Jersey and Luxembourg through its leading international law firm, Maples and Calder. With offices in key jurisdictions around the world, the Maples Group has specific strengths in the areas of corporate commercial, finance, investment funds, litigation and trusts. Maintaining relationships with leading legal counsel, Maples Group leverages this local expertise to deliver an integrated service offering for global business initiatives.

Authors

Christie Walton is a partner of the Cayman Islands funds and investment management team at Maples and Calder, the Maples Group's law firm. She specialises in the structuring, formation, restructuring and maintenance of offshore hedge and private equity funds. Christie advises on commingled funds, managed accounts and investment fund platforms, and acts for a wide variety of clients, including large financial institutions and investment managers, and smaller, start-up investment managers. She is a member of 100 Women in Finance and the Cayman Islands Legal Practitioners Association.

Patrick Rosenfeld is a partner of the Cayman Islands funds and investment management team at Maples and Calder, the Maples Group's law firm. He specialises in the formation and restructuring of all types of investment funds and advises clients in the asset management industry. Patrick also has extensive experience of international debt capital markets, structured finance and securitisation transactions.

Philip Dickinson is a partner of the Cayman Islands funds and investment management team at Maples and Calder, the Maples Group's law firm. He specialises in the structuring, formation and ongoing operation of Cayman Islands investment funds. He represents numerous private equity firms and fund managers in the establishment of fund structures, seed capital arrangements, restructurings, acquisitions and disposals, shareholder arrangements, joint ventures, downstream transactions and fund investment realisations. Philip also advises on compliance matters for funds and their operators and managers.

Contributed by: Christie Walton, Patrick Rosenfeld and Philip Dickinson, **Maples Group**

Maples Group

Ugland House
South Church Street
PO Box 309
Grand Cayman KY1-1104
Cayman Islands

Tel: +1 345 949 8066
Fax: +1 345 949 8080
Email: info@maples.com
Web: www.maples.com

1. Market Overview

1.1 State of the Market

The Cayman Islands is a popular domicile for globally managed private equity, credit, hedge and hybrid funds due to its tax neutral status, its flexible structuring options and its established and experienced financial services sector and professional service providers. Additionally, the Cayman Islands is recognised as an attractive jurisdiction for investment funds due to its English-based legal system, its established judiciary and the absence of political or sovereign concerns.

In particular, the Cayman Islands is the jurisdiction of choice for US sponsors structuring funds for US tax-exempt investors and non-US investors. Cayman Islands unit trusts and other vehicles are frequently used as investment vehicles for investors in Asia, including China and Japan.

The majority of investment funds established in the Cayman Islands are private non-retail funds.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Entity options available for structuring investment funds include exempted limited partnerships, exempted companies, limited liability companies and unit trusts. Closed-ended funds (such as private equity, credit and venture capital funds) are typically structured as exempted limited partnerships, and open-ended funds (such as hedge funds) make use of both exempted company and exempted limited partnership vehicles in standalone and master-feeder structures. Cayman Islands unit trusts are also frequently used as investment vehicles for investors in Asia, including China and Japan. The limited liability company is a popular choice for general partner and/or downstream holding vehicles.

A key difference between an exempted limited partnership and an exempted company is that, notwithstanding registration, an exempted limited partnership is not a separate legal person distinct from its partners. An exempted limited partnership must act through its general partner, and all agreements and contracts must be entered into by or on behalf of the general partner (or any agent or delegate of the general partner) under general legal principles of agency on behalf of the exempted limited partnership. Any right or property of the exempted limited partnership that is conveyed to, vested in or held either on behalf of the general partner or in the name of the exempted limited partnership is an asset of the exempted limited partnership held upon trust in accordance with the terms of the relevant law.

2.1.2 Common Process for Setting Up Investment Funds

The formation and registration processes in the Cayman Islands are streamlined and efficient. Exempted companies are formed upon the filing of a declaration and the memorandum and articles of association with the Registrar. Exempted limited partnerships and limited liability companies are formed upon the execution of the relevant operating agreement and the filing of a registration statement with the Registrar.

With limited exceptions, all open-ended funds must register with the Cayman Islands Monetary Authority (CIMA) under the Mutual Funds Act (As Revised), and all closed-ended funds must register with CIMA under the Private Funds Act (As Revised).

To register an open-ended fund, the requisite application form and offering memorandum must be submitted to CIMA in advance of the fund launch and directors must be registered under the Director Registration and Licensing Act. The administrator and auditor of the fund must submit consent letters confirming responsibility for these important roles.

To register a closed-ended fund, the requisite application form and offering memorandum (or summary of terms) must be submitted to CIMA within 21 days of a fund accepting capital commitments or, if earlier, prior to the fund receiving any capital contributions for the purpose of investments. The administrator and auditor of the fund must submit consent letters confirming responsibility for these important roles.

2.1.3 Limited Liability

The Cayman Islands legal system is based on well-recognised legal concepts founded in English law, including limited liability and separate corporate personality, which underpin the corporate, partnership and trust vehicles used as collective investment schemes, all of which were tried and tested and found to be robust during the 2008 global financial crisis.

As a general rule, in the absence of a contractual arrangement to the contrary, the liability of a shareholder of a Cayman Islands company that has been incorporated with limited liability and with share capital is limited to the amount from time to time unpaid in respect of the shares it holds. A Cayman Islands company has a legal personality separate from that of its shareholders, and it is separately liable for its own debts due to third parties.

A Cayman Islands exempted limited partnership does not have a legal personality separate from its partners. General partners have unlimited liability for all the debts and obligations of such partnerships by virtue of the Cayman Islands Exempted Limited Partnership Act (As Revised). Fund investors typically subscribe for limited partnership interests on which their liability is generally limited to their contributed capital and outstanding capital commitment (if any).

However, there are limited circumstances under Cayman Islands law whereby an investor who takes part in the conduct of the business of the partnership and holds itself out as a general partner to third parties may assume unlimited liability for the debts and obligations of the partnership. Exempted limited partnerships are the most common type of Cayman Islands vehicle used in private equity fundraising, and investors in such funds commonly seek Cayman Islands legal opinions in respect of the limited liability nature of their partnership interest, amongst other things.

2.1.4 Disclosure Requirements

Every mutual fund registered with CIMA (unless that fund is a "master fund" as defined under the Mutual Funds Act or a "limited investor fund" – see **2.3.1 Regulatory Regime**) is required to issue an offering document that must describe the equity interests in all material respects and contain such other information as is necessary to enable a prospective investor to make an informed decision as to whether or not to invest in the fund. CIMA has issued rules regarding the content of offering documents for registered mutual funds and rules regarding the content of marketing materials for registered private funds.

All fund offering documents are subject to the pre-existing statutory obligations with regard to misrepresentation and the general common law duties with regard to the proper disclosure of all material matters.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

The Cayman Islands is a popular domicile for globally managed private equity, credit, hedge and hybrid funds due to its tax neutral status, its flexible structuring options and its established and experienced financial services sector and professional service providers. In particular, the Cayman Islands is the jurisdiction of choice for US sponsors structuring funds for US tax-exempt investors and non-US investors. Cayman Islands unit trusts and other vehicles are frequently used as investment vehicles for investors in Asia, including China and Japan.

2.2.2 Legal Structures Used by Fund Managers

Closed-ended funds (such as private equity, credit and venture capital funds) are typically structured as exempted limited partnerships. Open-ended funds (such as hedge funds) are typically structured as exempted companies and/or exempted limited partnerships. Cayman Islands unit trusts are also frequently used as investment vehicles for investors in Asia, including China and Japan and may be structured as open-ended or closed-ended.

2.2.3 Restrictions on Investors

Unless a mutual fund is "licensed", "administered" or "limited" investor fund (see **2.3.1 Regulatory Regime**) or was registered with CIMA prior to 14 November 2006, all investors investing into a fund regulated by CIMA under the Mutual Funds Act are subject to an initial minimum investment amount of KYD80,000 (or its equivalent in another currency).

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Investment funds that fall within the definition of either a "mutual fund" under the Mutual Funds Act or a "private fund" under the Private Funds Act are required to be regulated by CIMA.

Mutual Funds

A mutual fund is any company, unit trust or partnership (established or registered in the Cayman Islands) that issues equity interests that are redeemable at the option of the investor, the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors to receive profits or gains from investments. Mutual funds that issue debt are excluded from regulation, even if the bonds or notes are convertible or have warrants attached.

There are four types of regulated mutual funds.

- The "licensed mutual fund" – A fund may obtain a licence from CIMA if CIMA considers that each promoter is of sound reputation, that the administration of the fund will be undertaken by persons who have sufficient expertise and are fit and proper to be directors (or, as the case may be, managers or officers in their respective positions), and that the business of the fund will be carried out in a proper way. The licensing process can take a few months and a fund must not commence operations until the licence has been granted. No regulatory minimum initial investment amount applies to this type of fund.
- The "administered mutual fund" – These funds are required to designate a principal office in the Cayman Islands at the office of a licensed mutual fund administrator (MFA). Instead of CIMA doing so, it is the MFA that is required to be satisfied that the promoter is of sound reputation, that the administration of the fund will be undertaken by persons who have sufficient expertise to administer the fund and are of sound reputation, and that the business of the mutual fund and the offer of equity interests will be carried out in a proper way. No regulatory minimum initial investment amount applies to this type of fund.
- The "registered mutual fund" –This type of fund is not subject to licensing, nor is it required to have a principal office provided by an MFA. However, it must have either (i) a minimum initial investment amount of at least KYD80,000 (or its equivalent in another currency) per investor, thus making it suitable only for sophisticated investors, or (ii) its equity interests listed on a recognised stock exchange, making it therefore subject to additional regulation by such stock exchange.
- The "limited investor fund" – This type of fund must have no more than 15 investors, who must be capable of appointing and removing the operator(s). Prior to the admission of a sixteenth investor, a limited investor fund will be required to re-register with CIMA under one of the other heads of regulation described above. Unlike a registered mutual fund, a limited investor fund is not subject to any minimum initial investment amount.

A "master fund" is defined under the Mutual Funds Act as a company, partnership or unit trust (established or registered in the Cayman Islands) that issues equity interests that are redeemable at the option of the holder to one or more investors, one of which must be another fund regulated by CIMA that conducts more than 51% of its investing in the "master fund" directly or indirectly (a "regulated feeder fund"). The "master fund" must hold investments or conduct trading activities for the principal purpose of implementing the overall investment strategy of the regulated feeder fund. Each fund that falls within the definition of a "master fund" is required to register as a "master fund" under the registered mutual fund category and is subject to the same minimum initial investment amount as a registered mutual fund.

All mutual funds regulated by CIMA (other than "master funds") are required to file offering documents or a summary of terms upon registration, and they must notify CIMA within 21 days of any material changes to service providers or the terms of the offering. In addition, all CIMA-regulated mutual funds must file audited accounts and a fund annual return within six months of their financial year-end.

Private Funds

A private fund is any company, unit trust or partnership (wherever established) that offers or issues or has issued investment interests, the purpose or effect of which is the pooling of investor funds with the aim of enabling investors to receive profits or gains from such entity's acquisition, holding, management or disposal of investments, where:

- the holders of investment interests do not have day-to-day control over the acquisition, holding, management or disposal of the investments; and
- the investments are managed as a whole by or on behalf of the operator of the private fund, directly or indirectly, but this does not include certain licensed or registered persons or any non-fund arrangements.

Global Fund Regulation Concerns: International Co-Operation, Fund Manager Domicile Requirements and AML Arrangements

CIMA has wide-ranging powers in respect of Cayman Islands entities that are regulated as mutual funds or private funds in the jurisdiction. CIMA has worked alongside overseas regulators in regulatory investigations involving investment funds, including the US Securities and Exchange Commission and the UK's Financial Conduct Authority.

There is no requirement for the investment manager or manager of a fund to be domiciled in the Cayman Islands or for a non-Cayman Islands manager or investment manager to be regulated in the Cayman Islands. Most fund managers are not domiciled in the Cayman Islands.

The Cayman Islands continues to adopt and embrace international best practice approaches for anti-money laundering (AML) and combatting terrorist and proliferation financing. The AML regime covers a wide range of investment entities, including all types of investment funds (whether regulated or not) in the Cayman Islands. All investment entities are required to appoint experienced risk and compliance professionals with specific knowledge of the Cayman Islands AML regime to the roles of anti-money laundering compliance officer (AMLCO), money laundering reporting officer (MLRO) and deputy MLRO. The AMLCO, in particular, will assist the investment entity in ensuring compliance with relevant requirements and, where the investment entity looks to rely upon a third party for carrying out AML/KYC checks on investors, the AMLCO will likely take a lead role in assessing the suitability of that third party. The AML regime requires the operators of investment entities, together with their AMLCO, to carry out a risk-based due diligence exercise when assessing the suitability of a service provider or a transaction counterparty and that this exercise should be tailored to the risk profile of each investment entity (taking into account its investor base and its anticipated investment activities). This continues to be a rapidly evolving area and the importance of retaining specialist risk and compliance professionals continues to rise.

The increasing compliance burden – not just in the Cayman Islands, but globally – has led to a sharp increase in outsourced administration and/or compliance services among closed-ended investment entities. Outsourced service providers are increasingly acting as a "one-stop shop" for compliance solutions where expertise and scalable data can result in marked increases in compliance efficiency.

2.3.2 Requirements for Non-Local Service Providers

There is generally no requirement for non-local service providers to be regulated in the Cayman Islands. However, all directors of companies regulated by CIMA as mutual funds under the Mutual Funds Act must be register with, or licensed by, CIMA pursuant to the Directors Registration and Licensing Act.

2.3.3 Local Regulatory Requirements for Non-Local Managers

There is generally no restriction on a fund manager from another jurisdiction managing a fund established as a Cayman Islands vehicle. However, if an overseas manager establishes a Cayman entity to act as the investment manager for a fund or other entity, such Cayman entity may be subject to licensing or registration with CIMA under the Cayman Islands Securities Investment Business Act (As Revised). A Cayman Islands entity acting as a discretionary manager of an investment fund may also be subject to local substance requirements under the Cayman Islands International Tax Co-operation (Economic Substance) Act (As Revised).

2.3.4 Regulatory Approval Process

Licensed mutual funds must apply to CIMA for a licence to operate. The licensing process can take a few months and a fund must not commence operations until the licence has been granted.

Administered mutual funds, registered mutual funds and limited investor funds must make an electronic filing with CIMA in the prescribed form and submit an offering document (or summary of terms), service provider consent letters and an application fee before the launch date.

Private funds must make an electronic filing with CIMA in the prescribed form and submit an offering document (or summary of terms), service provider consent letters and an application fee within 21 days of accepting capital commitments or, if earlier, prior to the fund receiving any capital contributions for the purpose of investments.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

See **2.3.6 Rules Concerning Marketing of Alternative Funds**.

2.3.6 Rules Concerning Marketing of Alternative Funds

The marketing of investment funds in the Cayman Islands does not require specific regulatory approval.

2.3.7 Marketing of Alternative Funds

Investment funds are typically established as either Cayman Islands exempted companies, exempted limited partnerships, limited liability companies or unit trusts. An exempted company that is not listed on the Cayman Islands Stock Exchange is prohibited from making any invitation to the public in the Cayman Islands to subscribe for any of its securities. Exempted limited partnerships and limited liability companies are prohibited from undertaking business with the public in the Cayman Islands other than so far as may be necessary for the carrying on of their business exterior to the Cayman Islands. If a trust is registered as an "exempted trust", investors must not – and must not be likely to – include any person who is resident or domiciled in the Cayman Islands (other than exempted and ordinary non-resident Cayman Islands companies or the object of a charitable trust or power).

The "public in the Cayman Islands" does not include:

- any exempted or ordinary non-resident company registered under the Cayman Islands Companies Act;
- a foreign company registered pursuant to Part IX of the Companies Act;
- a foreign limited partnership registered under Section 42 of the Cayman Islands Exempted Limited Partnership Act;
- any company acting as general partner of a partnership registered under the Exempted Limited Partnership Act; or
- any director or officer of the same acting in such capacity, or the trustee of any trust registered or capable of registration as an exempted trust under the Cayman Islands Trusts Act acting in such capacity.

2.3.8 Marketing Authorisation/Notification Process

See **2.3.6 Rules Concerning Marketing of Alternative Funds**.

2.3.9 Post-Marketing Ongoing Requirements

See **2.3.6 Rules Concerning Marketing of Alternative Funds**.

2.3.10 Investor Protection Rules

There are no investor protection rules that restrict the ownership of fund interests to certain classes of investors, except that a registered mutual fund must have a minimum initial investment amount of KYD80,000 (or its equivalent in another currency). Such a fund is geared toward more sophisticated investors and is subject to lighter-touch regulation by CIMA. A mutual fund that has a minimum initial investment amount of less than KYD80,000 (other than a limited investor fund) is subject to increased regulation by having to obtain a licence or having a "principal office" provided by a CIMA-licensed mutual fund administrator.

2.3.11 Approach of the Regulator

CIMA is a well-respected and dynamic regulator that consistently evolves its practice and approach to reflect the changing regulatory environment. CIMA has well-established consultation processes that are mandated by statute and allow for co-ordinated feedback from industry. CIMA has historically adopted a light-touch approach to enforcement, looking to assist in remedying breaches and minimising the chances of future errors rather than penalising regulatory oversights. However, there are signs that this approach is shifting, largely in response to external assessments, and the use of active enforcement to drive compliance is anticipated, particularly in the light of recent powers granted to CIMA to impose administrative fines for regulatory breaches without recourse to the judicial system.

As such, in addition to offences for non-compliance set out in the Mutual Funds Act and the Private Funds Act, CIMA now also has the power to impose administrative fines for breaches of prescribed provisions of such Acts committed by entities and individuals.

Breaches of prescribed provisions are categorised as being "minor", "serious" or "very serious". There is a sliding scale of fines, as follows:

- a fixed fine of KYD5,000 for minor breaches;
- up to KYD50,000 for individuals or KYD100,000 for entities for serious breaches; and
- up to KYD100,000 for individuals or KYD1 million for entities for very serious breaches.

Upon determination of a breach, CIMA will provide a breach notice to the relevant party. There will be a 30-day opportunity to reply to the breach notice and to rectify a minor breach to the Authority's satisfaction.

The potential for administrative fines reinforces the need for all operators of regulated investment funds to understand their obligations under the Mutual Funds and Private Funds Acts and to ensure that they maintain appropriate systems and controls to meet these obligations, as failure to do so could potentially result in the imposition of significant fines.

2.4 Operational Requirements

Legislation imposes no restrictions on the types of activity that may be undertaken by a Cayman Islands investment fund or the types of investments it may make. However, there are certain operational requirements imposed on mutual funds and private funds regulated by CIMA.

Mutual Funds

A regulated mutual fund needs to comply with the Net Asset Value (NAV) Calculation Rules and the Segregation Rules. The NAV Calculation Rules require a mutual fund to establish, implement and maintain pricing and valuation practices, policies and procedures (a NAV Calculation Policy) that ensure the fund's NAV is fair, complete, neutral, free from material error and verifiable.

The NAV of a mutual fund must be calculated by a service provider that is independent of the fund's investment manager/adviser and operators, and who is competent, has the capability to value the Portfolio of the fund and is able to adhere to the NAV Calculation Policy. A mutual fund's investment manager/adviser or operators may calculate or assist in the calculation of the fund's NAV but only if this fact is explicitly detailed in the fund's offering document, together with an explanation as to why another service provider could not calculate the fund's NAV.

The Segregation Rules require a regulated mutual fund to appoint a service provider with regard to ensuring the safekeeping of the fund's portfolio. A mutual fund's portfolio must be segregated and accounted for separately from the assets of any service provider. A mutual fund must ensure that none of its service providers uses the portfolio to finance their own or any other operations in any way.

The operators of a mutual fund must establish, implement and maintain (or oversee the establishment, implementation and maintenance of) strategies, policies, controls and procedures to ensure compliance with the Segregation Rules, consistent with the fund's offering document and appropriate for the size, complexity and nature of the fund's activities and investors.

Private Funds

The Private Funds Act contains certain operational requirements for a registered private fund, including provisions relating to the valuation of assets, the safekeeping of fund assets, cash monitoring and the identification of securities.

A private fund is required to establish, implement and maintain appropriate and consistent pricing and valuation practices, policies and procedures in order to properly value such private fund's assets and to ensure that valuations are conducted in accordance with the Private Funds Act.

A private fund is required to appoint a custodian, unless it has notified CIMA and it is neither practical nor proportionate to do so, having regard to the nature of the private fund and the type of assets it holds. If no custodian is appointed, a private fund must appoint an administrator or another independent third party or (subject to disclosing and managing any conflicts) the operator or investment manager/adviser to verify that the private fund holds title to its assets, and to maintain a record of those assets.

A private fund is required to monitor the cash flows, to ensure that all cash has been booked in cash accounts opened in the name, or for the account, of the private fund and to ensure that all payments made by investors in respect of investment interests have been received.

A private fund that regularly trades securities, or holds them on a consistent basis, is required to maintain a record of the identification codes of the securities in question.

Corporate Governance

In 2023, CIMA issued new Rules on Corporate Governance and Internal Controls (the "Rules") which created new regulatory obligations for CIMA-registered funds, including a requirement to establish, implement and maintain a corporate governance framework and adequate and effective internal controls. The new obligations do not appear to impact current operating practices in a material manner and there is flexibility in how and when the arrangements are implemented. CIMA expressly recognises that each fund's corporate governance framework and internal controls should reflect its size, complexity and structure, as well as the nature of its business and risk profile (by reference to, for example, assets under management, number of investors, complexity of the structure, nature of investment strategy, or nature of the operations). CIMA expressly contemplates that it is possible for a fund to rely on arrangements in place with its investment manager and other service providers to ensure compliance with these regulatory obligations. There is also a requirement for the "operator" or "governing body" of the fund (being the board of directors where the fund is a company, the general partner where the fund is a partnership and the manager (or equivalent) where the fund is a limited liability company and, in each case, needing to be comprised of at least two suitable natural persons) to hold at least one meeting annually in order to, amongst other things, confirm the continued adequacy of the corporate governance framework and to review and monitor the fund's activities and strategy, any conflicts of interest, financial statements and the activities and functions of service providers.

2.5 Fund Finance

The Cayman Islands is a leading fund finance jurisdiction where both Cayman Islands and non-Cayman Islands security packages are respected and recognised. Financing counterparties recognise the Cayman Islands as a "creditor-friendly" jurisdiction and are very familiar with, and comfortable lending to, all forms of Cayman Islands funds vehicles. Subscription line facilities secured on investors' capital commitments, NAV-based facilities with downstream collateral (eg, over the equity interest in holding vehicles), and leveraged finance facilities secured by the relevant target group's assets are very common and well-established products in the Cayman market.

There are no restrictions, issues or requirements imposed by Cayman Islands legislation, and Cayman Islands vehicles are able to access the full range of debt finance options seen in the market. Restrictions or requirements in relation to borrowing may, however, be contained in the constitutional and organisational documents of the Cayman Islands vehicle(s). These are discussed and negotiated by the sponsor and investors at launch, and/or with the finance provider at the outset of a new borrowing transaction, in the usual way.

Cayman Islands vehicles may be subject to, and may grant a wide range of, security packages that will vary depending on the deal type, other jurisdictions involved, and normal deal considerations and requirements. Cayman Islands vehicles are able to enter into both Cayman Islands and non-Cayman Islands security packages and documentation. All such arrangements will typically be recognised by the Cayman Islands courts, provided they are valid and enforceable under the laws of the relevant non-Cayman Islands legal system(s). As noted above, subscription line facilities secured on investors' capital commitments are particularly prevalent, and the use of NAV-based facilities is also growing in line with broader trends in the fund finance market. The Cayman Islands is also well-suited to deploying bankruptcy-remote structures, and there are well-established methods for implementing such structures across a range of commonly used Cayman Islands entities.

There are no significant issues in relation to fund finance transactions from a Cayman Islands legal perspective. As with any jurisdiction or deal, transaction participants should pay close attention to constitutional and organisational documents at the outset to ensure they are in a suitable form for the type of borrowing transaction and security package contemplated.

2.6 Tax Regime

The Cayman Islands tax system is predominantly based on indirect taxes, with government revenues being derived from the imposition of fees on the financial services industry, customs duties, work permit fees and tourist accommodation charges. Under existing legislation, the government of the Cayman Islands does not impose any form of direct tax on profits, income, gains or appreciations, nor by way of withholding in whole or in part on the payment of dividends or other distributions of income or capital by investment funds established in the Cayman Islands.

The Cayman Islands is not party to any double tax treaties with any country that are applicable to any payments made to or by investment funds established in the Cayman Islands.

The Cayman Islands entered into a Model 1B (ie, non-reciprocal) inter-governmental agreement to improve international tax compliance and the automatic exchange of information with the USA in 2013 (the "Cayman/US IGA"). A Cayman Islands financial institution shall be treated as complying with, and not subject to withholding under, Section 1471 of the US Code, so long as it complies with its obligations under the Cayman/US IGA and those contained in the Cayman Islands implementing legislation.

The Cayman Islands became a signatory to the Multilateral Competent Authority Agreement to implement the OECD Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard (CRS) with effect from January 2016.

Cayman Islands regulations have been issued to give effect to the Cayman/US IGA and CRS (collectively, the "AEOI Regulations"). Pursuant to the AEOI Regulations, the Cayman Islands Tax Information Authority has also published guidance notes on the application of the Cayman/US

IGA and CRS to financial institutions structured in the Cayman Islands.

All Cayman Islands financial institutions are required to comply with the registration, due diligence and reporting requirements of the AEOI Regulations.

From an investor's perspective, while the Cayman Islands adds no additional tax layer to the structuring of their global financial transactions, investee entities as well as investors are still subject to their home jurisdictions' relevant taxes and are responsible for complying with such obligations. As noted above, the Cayman Islands has adopted globally accepted standards for transparency and cross-border co-operation with foreign tax authorities and law enforcement agencies, and it automatically exchanges information with more than 100 worldwide revenue authorities annually, pursuant to the Cayman/US IGA and CRS (among other annual automatic exchange of information regimes).

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

The majority of investment funds established in the Cayman Islands are private non-retail funds. Indeed, a Cayman Islands company that is not listed on the Cayman Islands Stock Exchange is prohibited from making any invitation to the public in the Cayman Islands to subscribe for any of its securities, and exempted limited partnerships are prohibited from undertaking business with the "public in the Cayman Islands" other than so far as may be necessary for the carrying on of the business of the partnership exterior to the Cayman Islands.

For these purposes, "public in the Cayman Islands" does not include the following:

- any exempted or ordinary non-resident company registered under the Cayman Islands Companies Act (As Revised);
- a foreign company registered pursuant to Part IX of the Companies Act;
- a foreign limited partnership registered under Section 42 of the Cayman Islands Exempted Limited Partnership Act (As Revised);
- any company acting as general partner of a partnership registered under the Exempted Limited Partnership Act; or
- any director or officer of the same acting in such capacity or the trustee of any trust registered or capable of registration as an exempted trust under the Cayman Islands Trusts Act (As Revised) acting in such capacity.

Investors in an exempted trust registered under Part VI of the Trusts Act must not and must not be likely to include any person who is resident or domiciled in the Cayman Islands (other than exempted and ordinary non-resident Cayman Islands companies or the object of a charitable trust or power).

Subject to the above restrictions, certain categories of regulated open-ended mutual funds may be established without a statutory minimum investment requirement and therefore could be established as retail funds, although they are not common in the Cayman Islands.

There are four types of regulated open-ended "mutual funds" under the Mutual Funds Act.

- The "licensed mutual fund" – a fund may obtain a licence from CIMA if CIMA considers that each promoter of the fund is of sound reputation, that the administration of the fund will be undertaken by persons who have sufficient expertise and are fit and proper to be directors (or, as the case may be, managers or officers in their respective positions), and that the business of the fund will be carried out in a proper way. Funds that have obtained a licence from CIMA are not subject to a minimum initial investment amount.

- The “administered mutual fund” – this type of fund is not subject to a minimum initial investment; however, instead of going through the licensing process, the fund is required to designate a “principal office” in the Cayman Islands at the office of a CIMA-licensed mutual fund administrator.
- The “registered mutual fund” – this type of fund must have either (i) a minimum initial investment amount of KYD80,000 (or its equivalent in another currency), which will thus render it not suitable as a retail fund, or (ii) its equity interests listed on a recognised stock exchange. Any mutual fund that falls within the definition of a “master fund” under the Mutual Funds Act must register as a “master fund” under the registered mutual fund category.
- The “limited investor fund” – this type of fund must have no more than 15 investors, who must be capable of appointing and removing the operator(s). Prior to the admission of a sixteenth investor, a limited investor fund will be required to re-register with CIMA under one of the other heads of regulation described above. Unlike a registered mutual fund, a limited investor fund is not subject to any minimum initial investment amount.

3.1.2 Common Process for Setting Up Investment Funds

See **3.1.1 Fund Structures**.

3.1.3 Limited Liability

See **3.1.1 Fund Structures**.

3.1.4 Disclosure Requirements

See **3.1.1 Fund Structures**.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

See **3.1.1 Fund Structures**.

3.2.2 Legal Structures Used by Fund Managers

See **3.1.1 Fund Structures**.

3.2.3 Restrictions on Investors

See **3.1.1 Fund Structures**.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

See **3.1.1 Fund Structures**.

3.3.2 Requirements for Non-Local Service Providers

See **3.1.1 Fund Structures**.

3.3.3 Local Regulatory Requirements for Non-Local Managers

See **3.1.1 Fund Structures**.

3.3.4 Regulatory Approval Process

See **3.1.1 Fund Structures**.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

See **3.1.1 Fund Structures**.

3.3.6 Rules Concerning Marketing of Retail Funds

See **3.1.1 Fund Structures**.

3.3.7 Marketing of Retail Funds

See **3.1.1 Fund Structures**.

3.3.8 Marketing Authorisation/Notification Process

See **3.1.1 Fund Structures**.

3.3.9 Post-Marketing Ongoing Requirements

See **3.1.1 Fund Structures**.

3.3.10 Investor Protection Rules

See **3.1.1 Fund Structures**.

3.3.11 Approach of the Regulator

See **3.1.1 Fund Structures**.

3.4 Operational Requirements

See **3.1.1 Fund Structures**.

3.5 Fund Finance

See **3.1.1 Fund Structures**.

3.6 Tax Regime

See **3.1.1 Fund Structures**.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

BOTA

On 24 November 2023, the Parliament of the Cayman Islands passed the Beneficial Ownership Transparency Act (As Revised) (BOTA), which came into force on 31 July 2024. The BOTA implements a number of changes to the previous Cayman Islands beneficial ownership regime (BOR), including as follows:

- New in-scope entities – The prior regime applied only to companies, LLCs and LLPs. The BOTA brings additional types of entities into scope, including exempted limited partnerships. Non-Cayman Islands entities (including those registered as foreign persons in the Cayman Islands, typically to act as the general partner of an exempted limited partnership) and certain other categories of legal persons are carved out of BOTA (eg, certain charities and not-for-profits).
- Definition of beneficial owner – The BOTA provides for an updated definition of "beneficial owner" (based on ownership and/or control).
- Removal of exemptions – The majority of the exemptions that applied under the prior regime have been removed in favour of certain "alternative routes to compliance", meaning that the in-scope entity would not (where applicable) be required to report its beneficial owners, nor establish a beneficial ownership register, but rather report limited "required particulars".

Mutual funds and private funds registered with CIMA are able to apply an "alternate route to compliance" by which they must supply the contact details of a service provider licensed or registered under a regulatory law and located within the Cayman Islands that will provide beneficial ownership information to the competent authority on request within 24 hours (or any other time the competent authority may reasonably request).

In an investment fund structure, only the registered fund can take advantage of the alternative route to compliance, so other vehicles such as trading subsidiaries, blocker entities and general partner entities are in-scope and are required to establish and maintain a beneficial ownership register and to report the details of their beneficial owners to the competent authority on an ongoing basis. However, in the context of trading subsidiaries or blocker entities that are owned/controlled by the relevant Cayman

Islands investment fund, the BOTA requires the entity to report that Cayman Islands investment fund as a "reportable legal entity" but does not require the entity to look through that reportable legal entity in identifying registrable beneficial owners in that chain of control or ownership.

Potential Future Developments

The Cayman Islands government is committed to continually improving financial services as an important industry and has proposed a number of legislative reforms that it believes would be commercially advantageous to the jurisdiction, including a proposal to permit the merger and consolidation provisions (currently in place for exempted companies and limited liability companies) to be extended to exempted limited partnerships and a proposal to permit an exempted company or a limited liability company to convert to an exempted limited partnership.

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Felipe Díaz Toro, Victor Riadi and Ignacio Ruiz Rodríguez
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EDN Abogados is a prominent law firm based in Santiago, Chile, known for its comprehensive legal services and client-centric approach. The firm excels in bridging the gap between Latin America and the world's most sophisticated financial markets, offering tailored solutions that are both effective and efficient. The firm has a notable focus on the investment funds sector, and also specialises in corporate law, M&A, banking and finance, capital markets, dispute resolution and administrative law. It provides expert advice on structuring, establishing and managing investment funds, leveraging extensive experience in international financial law while also providing comprehensive transactional advice in the investment funds sector, advising institutional and qualified investors alike. With lawyers authorised to practise in Chile, Spain, Belgium and Luxembourg, EDN Abogados combines deep market knowledge with a multidisciplinary, innovative and international perspective. The firm is consistently recognised for its outstanding service and expertise, ensuring clients' profitability and sustainability through an integrated business philosophy.

Authors

Felipe Díaz Toro is a founding partner of EDN Abogados. He previously served as legal counsel at BBVA Bank in New York, as an associate at Arendt & Medernach (Luxembourg) and as a senior associate at Loyens & Loeff (Luxembourg). He holds a law degree (with honours) from Universidad Andrés Bello (2003), a Postgraduate Degree in Business Law from Universidad Católica de Chile (2005), an LLM in Banking and Financial Law from Boston University (2007) and an Advanced MBA from Universidad Adolfo Ibáñez (2019). Felipe is the only Chilean lawyer who has been authorised to practise law in Chile, Spain and Luxembourg.

Victor Riadi is a senior associate at EDN Abogados, with extensive experience in corporate law matters and advising high net worth individuals and large companies. Victor's practice focuses mainly on the review, negotiation and drafting of highly complex contracts, M&A operations, corporate reorganisations, corporate governance, restructuring of liabilities, and general compliance. He also regularly advises pension funds and asset managers on topics related to private and public funds, mainly focusing on alternative assets. Victor graduated from Universidad del Desarrollo.

Ignacio Ruiz Rodríguez is an associate at EDN Abogados, and previously worked in the M&A and corporate practices at Alcaíno | Abogados. He has prior experience in corporate law, joint ventures and mergers and acquisitions. At EDN Abogados, Ignacio is part of the investment funds team, focusing his practice on international financial law. He graduated from Universidad de Los Andes, Chile (2020).

EDN Abogados

Avenida Apoquindo 3669
Floor 4
Las Condes
Chile

Tel: +56 233 395 430
Email: administracion@ednabogados.cl
Web: www.ednabogados.cl

1. Market Overview

1.1 State of the Market

Chile's investment fund market has continued its slow-paced recovery towards growth over the past year.

The National Association of Mutual Funds reported that assets under management (AuM) held by mutual funds (FFMM) reached approximately USD62 billion by June 2023. After the 2022 decline in growth of 9%, the 2023 mid-year growth of 14% indicated a substantial recovery of all the AuM lost in 2022. Although these processes often respond to multiple variables, there is a general consensus that the main cause of said loss was due to the political uncertainty brought about by the constitutional initiatives regarding possible modifications of property rights and pension funds.

In 2023, most of the newly incorporated funds focused on real estate, infrastructure development and private debt. According to the 2023 Industry Report from the Chilean Association of Investment Funds (ACAFI), 68% of the 82 new investment funds invested in local assets and projects. The report also indicated a marked prevalence of alternative investment funds (605) over traditional investment funds focusing on purely financial assets (157).

The development of the investment fund industry has had a positive and significant impact on both GDP per capita and job creation since the enactment of Law No 20,712, published on 7 January 2014, on funds and portfolio management (*Ley Única de Fondos – Ley sobre Administración de Fondos de Terceros y Carteras Individuales*, or the Funds and Portfolio Management Law (LUF)). From 2014 to 2022, this positive impact led directly to the creation of 11,000 jobs annually. According to a study published by the CLAPES UC Latin-American Center for Economic and Social Policy, this amounts to a total of between 87,000 and 100,000 new jobs over the course of eight years. In addition, the report states that the sustained increase in AuM held by all public investment funds contributed, on average, USD14,442 per year to the GDP per capita between 2014 and 2022.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Chilean investment fund legislation does not provide for specific structures for funds investing in alternative assets.

In Chile, the distinction between FFMM and investment funds does not consider whether the types of assets in which these funds invest are traditional, alternative or a combination of the two. The investment strategy employed by the fund's manager is also not relevant in this regard. Consequently, investment in alternative assets in Chile may be structured through any of the legal structures permitted by law.

As mentioned in **1.1 State of the Market**, investment funds are governed by the LUF, which a decade ago provided a systematised, coherent and unified regulatory framework for the various types of investment funds permitted within the jurisdiction. The LUF is complemented by its rules, contained in Decree No 129. Significant attention must also be given to the role performed by the Chilean Financial Market Commission (*Comisión para el Mercado Financiero* CMF), in terms of its legal mandate to issue regulations for the application and enforcement of laws and regulations and, in general, to issue any other norms that, in accordance with the law, are incumbent upon it for the regulation of the financial market. Similarly, the CMF shall be responsible for the administrative interpretation of the laws, regulations and other rules governing the persons, entities or activities under its supervision, and may set rules and issue instructions and orders for their application and compliance.

Through these regulations, among others that it is authorised to enact, the CMF has established a comprehensive regulatory framework pertaining to investment funds. An exception to this rule is in respect of Chilean pension funds, which continue to be regulated separately in terms of both their structure and the investments they are allowed to make, which are set out in various legal bodies, including Decree Law 3500, the Compendium of Pension System Regulations, the Compendium of Central Bank Financial Regulations, the Pension Funds Investment Regime and other regulations issued by the Chilean Pensions Supervisor or any governmental authority with regulatory jurisdiction in specific aspects of the applicable legislation (collectively, “Chilean Pension Regulations”).

The primary classification established by the LUF regarding investment funds is based on whether the investors’ units are redeemable. If the units are redeemable and this redemption is executed within ten days from the request, the fund will be considered an FFMM. If the units are redeemable but the redemption is carried out between 11 and 179 days from the request, the fund will be considered a redeemable investment fund. Finally, if the redemption occurs in 180 days or more, the fund will be considered a non-redeemable investment fund. This initial classification has significant implications for the fund’s structure, operational burden and frequency of regulatory reporting.

In addition, Chilean regulation differentiates between a private investment fund (FIP), which must have a minimum of eight investors and a maximum of 49 (who cannot belong to the same family, as stipulated in the LUF) and a public investment fund (FI), which must have a minimum of 50 investors. The primary consequence of this classification pertains to the level of supervision the CMF will exercise over the fund.

The primary advantages of structuring investments in alternative assets through an FIP include:

- the flexibility of its
- *Reglamento Interno* (“by-laws”);
- the low cost of maintaining the structure;
- the minimal regulatory compliance required from its fund manager (as defined in **2.1.4 Disclosure Requirements**); and
- the speed of its set-up process.

However, due to the maximum limit of 49 investors, it is challenging to diversify participation among a sufficient number of investors unless the fund is targeted at large national or foreign qualified or institutional investors. Attracting such investors can be difficult, as the FIP is not subject to the direct supervision of the CMF.

By structuring investments in alternative assets through an FI, the oversight role of the CMF provides greater security to investors due to the regulatory controls imposed upon them. Although the minimum number of investors for this type of fund is 50, this requirement does not apply if an institutional investor (either local or foreign) is among them. The set-up process for this type of investment fund is slower and its maintenance involves higher costs, primarily due to the operational and regulatory requirements.

Investments made in Chilean investment funds are materialised in "units", which are the equivalent of participating shares in a typical limited partnership/general partnership structure. These units represent the investor's participation in the fund. The investor's liability is limited to the amount of their contribution.

2.1.2 Common Process for Setting Up Investment Funds

The incorporation time for an alternative investment fund can vary significantly depending on whether it is structured as an FI or an FIP.

The set-up process of an alternative investment fund is directed by the fund manager, which must be legally structured as outlined in **2.2.2 Legal Structures Used by Fund Managers**. Once the fund manager has finalised the draft of the respective fund's by-laws, its board of directors must pass a resolution approving them.

- For FIs, there is an additional requirement whereby the fund manager must deposit the approved by-laws, along with a dossier of supplementary documents concerning the newly created fund, in the Public Registry of Funds administered by the CMF. The CMF has the authority to raise objections to the supporting documentation or specific aspects of the by-laws.
- Pursuant to Article 46 of the LUF, the fund manager must deposit the by-laws of the investment fund and all additional documents as specified in NCG No 365 of 2014 of the CMF (NCG 365), following the instructions and specific forms available on the CMF's online portal.
- The incorporation process for an FIP is relatively straightforward and expeditious. Conversely, for FIs, the drafting of by-laws requires extensive analysis and adjustment to comply with the provisions established in the LUF and NCG 365. The drafting of the necessary documents for the CMF deposit can require several hours of professional work, and may require the intervention of third parties to produce documentation (custodians, independent valuators, external auditors, etc). The fund manager must also submit a similar set of documents to Chile's Internal Tax Revenue Service web portal to obtain a tax identification number for the investment fund, which adds between three and five working days to the set-up process.
- It is particularly relevant to note that the documents to be deposited with the CMF for each FI must include a guarantee in favour of each investment fund for an initial amount equivalent to 10,000 *Unidades de Fomento* (a common inflation index unit widely used in various provisions of the LUF), which currently amounts to approximately USD400,000.

2.1.3 Limited Liability

As mentioned in **2.1.1 Fund Structures**, investments in any fund domiciled in Chile are represented by units of the respective fund, thereby limiting the liability of investors for the fund's obligations up to the amount they have contributed for their respective units. Accordingly, the fund manager is not liable for the obligations of the fund with its own assets.

The LUF does not contain provisions allowing for the lifting of the corporate veil. General rules permitting the piercing of the corporate veil have been applied judicially in a restrictive and exceptional manner.

2.1.4 Disclosure Requirements

Regarding the nature of the assets in which they invest, there are no specific disclosure requirements for alternative investment funds.

Pursuant to paragraph 3 of the LUF and NCG No 386 and NCG No 461 of the CMF, fund managers are required to disclose information concerning their managed funds. The extent and scope of such disclosure depend on the type of fund manager, as outlined in **2.2.2 Legal Structures Used by Fund Managers**.

For FIs, the *Administradora General de Fondos* (AGF, which in Chile corresponds to a certain type of fund manager) must ensure the truthful, sufficient and timely disclosure of information regarding the fund's main characteristics (as set forth in its by-laws), financial statements, investor registry and corporate governance. All specific details concerning the disclosure of different series of units pertaining to a fund must be provided. Recently, the fulfilment of certain environmental, social and governance (ESG) standards has also been included within the disclosure requirements for AGFs.

From a procedural perspective, such disclosure is initially provided to the CMF through the SEIL web portal. The CMF then makes it accessible to the general public. The fund manager must also provide access to the documents submitted to the CMF through its own website and maintain printed copies of some of these documents in their offices, which shall be available to FI investors. None of these disclosure requirements are mandatory for FIPs.

However, *Administradoras de Fondos de Inversión* (AFI, which in Chile corresponds to private investment fund managers; together with AGFs, "fund managers") are still required to comply with the obligation to register in the CMF's Special Registry of Reporting Entities. This status as a reporting entity imposes fewer reporting obligations compared to those applicable to AGFs. In addition to providing their corporate information and supporting legal documents, AFIs must fulfil the obligation to submit updated information to the CMF regarding the FIPs under their administration on a quarterly basis. The background information included in this submission encompasses the name and valid tax identification number of each fund, a detailed list of its investors and the valuation of its assets and liabilities, including a description of the accounting methods used in such valuation.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

The majority of the active FIs within the Chilean industry target alternative assets. According to an April 2024 press release from the ACAFI, more than 70% of the investment funds managed by these companies invest in alternative assets, and more than 50% of them go to national assets. This year's reform of the Chilean Pensions Regulations will only increase said appetite; see **4.1 Recent Developments and Proposals for Reform**.

2.2.2 Legal Structures Used by Fund Managers

There is no specific legal structure imposed on fund managers by local regulations based solely on the management of alternative assets through investment funds. The legal structure is determined exclusively by whether the fund manager will oversee the management of an FI or an FIP, as described in **2.1.2 Common Process for Setting Up Investment Funds**. In both instances, the fund manager must be domiciled in Chile.

FIs must be managed by a particular type of regulated, closely held stock corporation (*Sociedad Anónima Especial*) that requires prior authorisation from the CMF and is subject to ongoing supervision. These are special corporations whose sole purpose is the management and administration of third-party funds, for which the Law of Stock Corporations, the LUF and the regulation of the CMF establish complex authorisation requirements. This type of corporation is referred to as an AGF (see **2.1.4 Disclosure Requirements**) and is subject to substantial reporting requirements, minimum capital requirements and ongoing personnel accreditation monitoring.

FIPs may be managed by an AGF but can also be managed by a softly regulated, closely held corporation known as an AFI (see **2.1.4 Disclosure Requirements**).

2.2.3 Restrictions on Investors

No specific requirements are imposed on fund investors as a direct consequence of their investments in alternative assets or considering the type of investor. An exception to this rule is established in the Chilean Pension Regulations, which maintain stringent controls on the percentage of investments permitted to be allocated in alternative assets.

Recent developments have allowed for an expanded threshold for pension funds investing in alternative assets, as explained in **4.1 Recent Developments and Proposals for Reform**.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Chilean regulation does not impose specific investment limitations on alternative funds per se, with the exception of the specific restrictions applicable to pension funds under the Chilean Pension Regulations.

However, certain investment prohibitions and limitations apply to all funds, regardless of whether they are FFMMs, FIs or FIPs. Funds are prohibited from directly investing in real assets, mining properties, water rights, property rights, industrial or intellectual property, and vehicles of any type. Funds are also not permitted to engage directly in:

- industrial, commercial, real estate, agricultural, mining, exploration, exploitation or extraction activities;
- insurance or reinsurance activities; or
- any other business that involves the direct development of a commercial, professional, industrial or construction activity by the fund.

In general, funds are restricted from undertaking any activity directly other than investment. To engage in such activities or hold said assets, investment funds typically invest in special purpose vehicles (SPVs), which own the portfolio assets or engage in these activities. This investment in an SPV is materialised through either equity or debt.

In addition, pursuant to Article 58 of the LUF, funds must comply with limitations on investments made in equity or debt instruments issued by parties related to their fund manager. Finally, according to NCG No 376 (NCG 376), additional restrictions and reporting obligations apply exclusively to FIs when investments are made in offshore jurisdictions.

2.3.2 Requirements for Non-Local Service Providers

The original organisational framework established by the LUF in 2014 vested the fund manager with all the responsibilities and operational capabilities necessary for an investment fund to function. Exceptionally, the fund manager must appoint a custodian regulated by the CMF when the asset class in which the fund invests requires such a service. They are also required to appoint a fund auditor from among those registered in the CMF Register of External Auditing Entities.

Pursuant to CMF Circular Letters No 657 of 2011 and No 592 of 2010, if the fund's by-laws permit payment in kind (of units), the fund manager must appoint an independent valuator. A similar appointment must be made for the valuation of alternative assets.

As fund service providers have gained further specialisation, fund managers have increasingly outsourced a broader scope of services, including compliance services, IT providers, investment brochures or prospectus design services, and investor services platforms, which generally are not subject to licensing or authorisation.

It is important to note that, despite the outsourcing of these tasks and services, the fund manager's liability for the management of the fund is non-delegable, as stated in Article 15 of the LUF. Consequently, clauses that limit the responsibility of the fund manager for the actions of outsourced service providers are not enforceable against third parties.

2.3.3 Local Regulatory Requirements for Non-Local Managers

Under Chilean regulation, fund managers are the default providers of both fund administration and fund management.

As mentioned in **2.2.2 Legal Structures Used by Fund Managers**, all Chilean fund managers must be domiciled in Chile. However, the LUF allows for the outsourcing of some tasks and responsibilities to an external manager, either local or foreign, as long as the extent of such activities and the costs involved are established in the fund's by-laws.

2.3.4 Regulatory Approval Process

According to the LUF, the fund manager has a maximum of 180 days to begin marketing the fund, counted from the filing of the respective by-laws. Given that the CMF may present objections or observations to the by-laws of FIs or other documentation submitted in relation to each new investment fund, as described in **2.2.2 Legal Structures Used by Fund Managers**, the revision of these documents may be prolonged.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

With the exception of rules established for the private offerings of FIPs (as explained below), there are no pre-marketing provisions contained in local regulations for alternative funds.

Units would be classified as a security in Chile. Active and/or passive marketing of funds is permitted, provided that an exemption to the public offering registration requirement is complied with. An offer is not a public offering and can be offered without prior registration where it is exclusively and privately targeted to a certain type of investors (institutional investors). On the contrary, any public offering of securities (which includes fund units) must be preceded by the registration with the CMF of both the issuer and the securities or class of securities being offered.

The public marketing and selling of fund units in Chile requires registration of the fund and its units with the CMF. The selling and intermediation of fund units in Chile requires the appropriate brokerage licence, as fund units fall within the meaning of "securities" under the Securities Market Law.

For the purposes of this exemption, an offering will be held to be exclusively and privately conducted if it is aimed at certain eligible investors and there is no use of mass media means of dissemination, such as the press, radio, television and the internet accessible publicly inside or from Chile, regardless of the place where they are produced or broadcasted. For the avoidance of doubt, this exemption provides that the following media shall not be considered to be mass media means of dissemination:

- letters, emails and other communications, whether physical or electronic, that are exclusively addressed to a designated person identified in the communication; and
- telephone calls, meetings, personal interviews and electronic systems of restricted access.

Pursuant to NCG No 336 of the CMF ("NCG 336"), an offer of securities shall not constitute a public offer, provided the person making the offer complies with the disclosure requirements and adopts the compliance procedures established in NCG 336.

Securities sold on a private placement basis must comply with the compliance requirements established in NCG 336, Section IV of which provides that the individuals or entities that make private offers of securities, in accordance with the general rule issued by the CMF, will be responsible for adopting all necessary measures and safeguards in order to:

- verify the identity and status as a qualified investor of the persons to whom the offers of the securities are addressed;
- comply with the conditions, limits and amounts necessary for the offer to be considered a private offer of securities; and
- accredit, whenever instructed to do so by the CMF, the due compliance of the obligations set forth in NCG 336.

Securities sold on a private placement basis must comply with the disclosure requirements established in NCG 336. FIPs cannot perform any marketing activities besides private offerings of their units in accordance with NCG 336, which establishes the following requirements and procedures:

- a maximum of 50 non-qualified investors;
- a maximum of 250 high net worth individuals;
- qualified investors only; and
- entities managed exclusively by qualified investors.

Said private offering must provide acknowledgement of the following to targeted investors:

- The offering is performed in accordance with the requirements set out in NCG 336 of the CMF.
- It refers to non-registered units of a fund and, consequently, its public offering is not allowed.
- The units represent participations in a fund unsupervised by the CMF.
- The issuing fund is not obliged to inform the CMF of the characteristics of the units.

2.3.6 Rules Concerning Marketing of Alternative Funds

Alternative investment funds are not subject to specific marketing rules, with the exception of the rules established for the private offerings of FIPs. The marketing of MMFFs and FIs is governed by the rules set for the offering of securities, while FIPs can only perform a private offering. In this regard, the LUF expressly establishes a prohibition on performing any public offer of FIP units, their profitability or the promotion of private fund management service.

Any type of communication or information issued regarding a FIP must necessarily disclose that these funds are not regulated or supervised by the CMF.

FIPs are subject to significantly less strict CMF oversight than FIs, as mentioned in **2.1.4 Disclosure Requirements**. Accordingly, AFIs managing such funds are subject to less stringent oversight by the CMF, and the private offering of their units must comply with NCG 336, as mentioned in **2.3.5 Rules Concerning Pre-marketing of Alternative Funds**.

Rules regarding the marketing of securities apply to FFMMs and FIs, as their units must be previously registered with the CMF. Pursuant to NCG 365, the fund manager must then provide target investors with the following information:

- the fund’s by-laws (as previously deposited in the CMF Register of Fund By-laws);
- the general subscription agreement of the fund manager;
- the specific subscription agreement for the marketed fund;
- the informative brochure of the fund, issued in accordance with CMF guidelines (allowing for an informed investment decision based on its historical revenues, the fund’s investment thesis, the fund’s particular risks, the portfolio composition, etc); and
- financial statements sent by the fund manager to the CMF.

2.3.7 Marketing of Alternative Funds

Alternative funds can be marketed to any type of local or foreign investor, except for those governed by the pension fund investment regime, which imposes stringent controls on the percentage of investments allowed in alternative assets, as mentioned **in 2.2.3 Restrictions on Investors**.

2.3.8 Marketing Authorisation/Notification Process

No specific authorisation or notification is required for alternative investment funds per se, except those mentioned in **2.3.6 Rules Concerning Marketing of Alternative Funds**.

2.3.9 Post-Marketing Ongoing Requirements

Fund managers are required to comply with ongoing disclosure and reporting requirements to the CMF regardless of the type of asset class, strategy or investments made by the investment funds under their management. These obligations include the updating of all marketing materials related to the funds under management, as outlined in **2.3.6 Rules Concerning Marketing of Alternative Funds**.

AFIs are subject to a lesser degree of oversight by the CMF; therefore, the ongoing marketing requirements for FIPs must adhere to the provisions mentioned in **2.3.5 Rules Concerning Pre-marketing of Alternative Funds** regarding the private offering of FIP units.

Conversely, AGFs are subject to significantly higher regulatory requirements, which include the reporting of information regarding the fund, including an updated version of the fund’s by-laws and its respective informative brochure. These reporting obligations must be fulfilled at least quarterly in accordance with the deadlines and requirements set forth in NCG No 30 of the CMF.

2.3.10 Investor Protection Rules

An offer subject to NCG 336 has to be exclusively and privately targeted to eligible investors in Chile, which corresponds to institutional investors. There are no specific investor protection provisions regarding alternative investment funds or restrictions other than those mentioned in **2.3.1 Regulatory Regime**.

2.3.11 Approach of the Regulator

Under Chilean law, any public entity may be the subject of a request for contact or a meeting with its officials, through compliance with current administrative regulations.

Generally, the fund manager is responsible for approaching the CMF regarding any existing or newly created investment funds. Pursuant to NCG No 314 of the CMF, fund managers must engage with the CMF through a web portal known as SEIL.

To contact a public service such as the CMF under Chile's Lobbying Law 20.730, a regulated and transparent process must be followed. Initially, a request for a hearing or meeting must be submitted, detailing the purpose and topics of the interaction. The public entity (in this instance the CMF) will review the request and, upon approval, schedule the meeting. All interactions are documented and published on the Lobby Law website, ensuring transparency and public access to information.

Despite the highly regulated communication channels, the CMF is approachable, even through face-to-face meetings, provided all rules applicable to lobbying are fulfilled in accordance with the provisions set forth in Law No 20.730 and its Rules contained in Decree No 71 of 2014.

2.4 Operational Requirements

Investment funds targeting alternative assets must comply with specific restrictions set forth in Article 57 of the LUF.

- As previously mentioned, alternative investment funds cannot directly engage in activities or own assets traditionally considered within the scope of alternative investments, such as developing agribusiness facilities, building grid infrastructure, owning commercial real estate or holding mining concessions.
- When the nature of said alternative assets permits custody, the fund manager is obliged to protect them through the appointment of a depository company regulated by the CMF and registered in the Central Securities Depository. There are specific requirements regarding investments in assets located in different jurisdictions and the custody held by foreign entities.
- There are no specific requirements regarding investment limits, borrowing, anti-money laundering (AML) or further regulatory measures solely in consideration of the alternative nature of the invested assets. Pursuant to Article 59 of the LUF and NCG 376, fund managers must ensure that funds comply with specific investment and borrowing provisions, which are particularly important for mutual funds targeting retail (non-qualified) investors. In addition, fund managers must continually provide the CMF with updated manuals containing all risk assessment and mitigation protocols in accordance with the risks inherent to all funds under management and the fund manager itself, in accordance with the recently issued NCG No 507 of the CMF. This regulation imposes specific risk assessment requirements regarding the investment cycle of the fund, including both subscription and redemption cycles and its accounting practices.

The fulfilment of the risk management requirements established in NCG No 235 of the CMF regarding the valuation and protection of assets subject to custody is particularly relevant. In addition to the oversight performed by the CMF, both AGFs and AFIs are supervised by the *Unidad de Análisis Financiero* (Financial Analysis Unit, or UAF), which is an autonomous governmental agency responsible for the prevention of money laundering and terrorism financing. As a consequence, fund managers are the reporting entities for a wide scope of activities undertaken by FFMMs, FIs and FIPs as participants in the financial markets. To comply with local AML/Know Your Customer (KYC) controls, source of funds declarations and ultimate beneficial ownership information are mandatory for investment fund investors and fund managers.

2.5 Fund Finance

Chilean investment fund regulation does not impose specific rules on alternative investment funds, notwithstanding the general provisions established under the LUF and the CMF's general regulations concerning fund financing.

- The financing market for investment funds is well developed but, in practice, investment funds are typically established as lenders or capital providers rather than borrowers. As a general rule, lending operations are consistently secured by some form of collateral asset or debt instrument.
- For FFMMs that focus on alternative investments and target non-qualified investors, Article 20 of the LUF stipulates a maximum debt threshold equivalent to 20% of the fund's AuM. Additional regulations concerning borrowing limits are outlined in NCG 376. Furthermore, NCG 365 mandates that any restrictions on borrowings must be incorporated as a provision in the by-laws of each investment fund. Such provisions generally specify a maximum percentage of the fund's AuM or committed capital.

2.6 Tax Regime

There is no specific tax incentive scheme for alternative investment funds. Benefits are provided to investment funds, regardless of the type of assets in which they invest. The main benefit consists in the exemption of corporate tax at the fund level. However, as mentioned in **2.3.1 Regulatory Regime**, investment funds cannot directly undertake activities or own assets typically deemed as alternative investments, so an SPV portfolio company must be interposed between such activities or assets and the fund. The SPV will be fully liable to the general tax regime and, thus, subject to corporate tax rates.

Both FIs and FIPs are allowed to defer taxation until distributions are made to investors. Pursuant to Article 80 of the LUF, mandatory distributions of at least 30% of accrued profits must be made on a yearly basis.

Once distributions are made to investors, different tax consequences will arise depending on the intrinsic characteristics of the investors and, in some cases, whether the distribution was made by an FI or an FIP.

- Resident Individuals: Natural persons as investors of an FI will be deemed final taxpayers and thus subject to a personal income tax on fund distributions, called
- *Impuesto Global Complementario* (IGC) at a 0% to 40% progressive rate. Said final taxpayers are allowed to use 65% of the corporate tax levied at the SPV level as a credit against their due IGC.
- Resident Entities: Local corporate entities receiving fund distributions will not be deemed as final taxpayers and thus will not

be subject to corporate income tax on said distributions.

- Non-Resident Investors: Distributions made to non-resident investors (either natural persons or corporate entities) by FIPs will be subject to a withholding tax (*Impuesto Adicional*) at a 35% rate. Said foreign taxpayers are allowed to use 65% of the corporate tax levied at the SPV level as a credit against the aforementioned withholding tax. If such dividend was paid by an FI, there is no withholding tax applicable. Instead, a sole tax (*Impuesto Único*) established by the LUF will be levied at a 10% tax rate (no tax credit for corporate tax levied at SPV level applies).
- Institutional Investors: Distributions made to a Chilean pension fund are not subject to taxation.

Taxation of sales and redemptions regarding units of an FI are deemed capital gains. In general, they are subject to income tax, be it corporate income tax or IGC, with the following exceptions:

- Income tax will not apply when said redemptions are a consequence of the fund's liquidation.
- Neither tax applies when redemptions derive from a capital decrease.
- Redemptions made by a non-resident investor will be levied with the sole tax (*Impuesto Único*) established by the LUF (10% rate).

The taxation of sales and redemptions regarding units of an FIP are also deemed capital gains, subject to income tax, be it corporate income tax or IGC. However, if such redemptions are made by a non-resident investor it will be levied with a withholding tax at a 35% rate (allowing the use of 65% of the corporate tax levied at the SPV level as a credit against said withholding tax).

In addition, a full tax exemption on dividends or capital gains derived from redemptions and sales of units can be granted to non-resident investors in both FIs and FIPs, provided that at least 80% of the fund's investment portfolio is comprised of assets located abroad or securities issued by an entity domiciled in a different jurisdiction.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

See **2.1.1 Fund Structures**.

3.1.2 Common Process for Setting Up Investment Funds

See **2.1.2 Common Process for Setting Up Investment Funds.**

3.1.3 Limited Liability

See **2.1.3 Limited Liability**.

3.1.4 Disclosure Requirements

See **2.1.4 Disclosure Requirements**.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

See **2.2.1 Types of Investors in Alternative Funds.**

3.2.2 Legal Structures Used by Fund Managers

See **2.2.2 Legal Structures Used by Fund Managers.**

3.2.3 Restrictions on Investors

See **2.2.3 Restrictions on Investors**.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

See **2.3.1 Regulatory Regime**.

3.3.2 Requirements for Non-Local Service Providers

See **2.3.2 Requirements for Non-local Service Providers**.

3.3.3 Local Regulatory Requirements for Non-Local Managers

See **2.3.3 Local Regulatory Requirements for Non-local Managers**.

3.3.4 Regulatory Approval Process

See **2.3.4 Regulatory Approval Process**.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

See **2.3.5 Rules Concerning Pre-marketing of Alternative Funds**.

3.3.6 Rules Concerning Marketing of Retail Funds

See **2.3.6 Rules Concerning Marketing of Alternative Funds**.

3.3.7 Marketing of Retail Funds

See **2.3.6 Rules Concerning Marketing of Alternative Funds**. Investment funds targeting 50 or more investors must be structured as FIs (public funds only).

3.3.8 Marketing Authorisation/Notification Process

See **2.3.8 Marketing Authorisation/Notification Process**.

3.3.9 Post-Marketing Ongoing Requirements

See **2.3.9 Post-marketing Ongoing Requirements**.

3.3.10 Investor Protection Rules

See **2.3.10 Investor Protection Rules**.

3.3.11 Approach of the Regulator

See **2.3.11 Approach of the Regulator**.

3.4 Operational Requirements

See **2.4 Operational Requirements**.

3.5 Fund Finance

See **2.5 Fund Finance**.

3.6 Tax Regime

See **2.6 Tax Regime**.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

In the past three years, and in line with current global trends, both the OECD and the IMF issued recommendations, through the Growth and Equity Tax Commission, in order to minimise the tax benefits bestowed on investment funds by Chilean legislation. These recommendations led to the introduction of a 2022 bill seeking to eliminate the tax deferral benefit for private investment funds. However, the bill failed to secure sufficient legislative support to implement the proposed tax reform.

In April 2024 there was a decision by Chile's Central Bank regarding the alternative investment threshold allowed for the pension fund regime. This decision is intended to enhance the profitability of pension funds while improving the allocation of investments in alternative assets. As a result, the alternative investment sector in Chile anticipates growing interest in real estate, private equity, private debt, and infrastructure investment funds, particularly in light of the gradual increase in limits on pension fund investments in alternative assets.

In recent developments, regarding Investment Funds, on 23 December 2024, the Financial Market Commission (CMF) published General Rule No 526 (NCG 526), replacing NCG No 157 of 2003. This new regulation establishes updated minimum equity and guarantee requirements for fund managers. It introduces differentiated criteria based on the type and volume of operations conducted by administrators, dividing them into two categories:

- Block 1: Managers with fewer than 50 non-institutional clients and without the characteristics of Block 2 are exempt from minimum equity requirements.
- Block 2: Managers with more than 50 clients, at least one institutional client, or those exceeding specific thresholds for assets under management or income are required to maintain a minimum equity of 5,000 UF or 3% of their risk-weighted assets, in addition to adjustable guarantees for the benefit of the funds they manage.

The regulation introduces a more advanced methodology for calculating risk-weighted assets, accounting for operational, credit, and market risks, including specific classifications for crypto-assets. The implementation of NCG 526 will be mandatory as of 1 January 2026, while provisions related to risk management will come into effect on 1 July 2027. Managers must assess their classification and adapt their operations to meet these new regulatory standards.

On the same date, the CMF issued General Rule No 527 (NCG 527), introducing significant changes to NCG No 507 on corporate governance and risk management, as well as NCG No 468, which governs the authorisation of fund managers' functions. This regulation includes a new section on the risk management quality assessment, allowing the CMF to evaluate the effectiveness of fund managers' controls, policies, and procedures. The assessment considers risks such as credit, market, liquidity, operational, money laundering, and conduct. Fund managers will be rated on a global scale based on their compliance, identifying areas for improvement in governance and risk management.

Additionally, NCG 527 mandates an annual risk management self-assessment, which must be approved by the board of directors and submitted to the CMF within 30 days after the end of each financial year. This self-assessment must address compliance with regulations related to organisation, internal controls, and risk mitigation.

NCG 527 applies immediately, except for the self-assessment provisions, which will become mandatory as of 1 July 2027.

On a broader level, an important development affecting the fund industry will be the reform to the Pension Fund System approved by Chile's congress in late January 2025. This is expected to introduce significant changes to the regulatory framework governing pension fund investments, including an important increase to the system's assets under management, fewer regulatory and capital restraints for pension fund managers and a reward and punishment system for performance against a benchmark, both which should open the market for new players, governmental entities in supporting roles to private fund managers, among others. Additionally, the reform includes stricter governance requirements and enhanced transparency measures to ensure the prudent management of pension fund resources.

Trends and Developments

Contributed by:
Felipe Díaz Toro, Victor Riadi and Ignacio Ruiz Rodríguez
EDN Abogados

EDN Abogados is a prominent law firm based in Santiago, Chile, known for its comprehensive legal services and client-centric approach. The firm excels in bridging the gap between Latin America and the world's most sophisticated financial markets, offering tailored solutions that are both effective and efficient. The firm has a notable focus on the investment funds sector, and also specialises in corporate law, M&A, banking and finance, capital markets, dispute resolution and administrative law. It provides expert advice on structuring, establishing and managing investment funds, leveraging extensive experience in international financial law while also providing comprehensive transactional advice in the investment funds sector, advising institutional and qualified investors alike. With lawyers authorised to practise in Chile, Spain, Belgium and Luxembourg, EDN Abogados combines deep market knowledge with a multidisciplinary, innovative and international perspective. The firm is consistently recognised for its outstanding service and expertise, ensuring clients' profitability and sustainability through an integrated business philosophy.

Authors

Felipe Díaz Toro is a founding partner of EDN Abogados. He previously served as legal counsel at BBVA Bank in New York, as an associate at Arendt & Medernach (Luxembourg) and as a senior associate at Loyens & Loeff (Luxembourg). He holds a law degree (with honours) from Universidad Andrés Bello (2003), a Postgraduate Degree in Business Law from Universidad Católica de Chile (2005), an LLM in Banking and Financial Law from Boston University (2007) and an Advanced MBA from Universidad Adolfo Ibáñez (2019). Felipe is the only Chilean lawyer who has been authorised to practise law in Chile, Spain and Luxembourg.

Victor Riadi is a senior associate at EDN Abogados, with extensive experience in corporate law matters and advising high net worth individuals and large companies. Victor's practice focuses mainly on the review, negotiation and drafting of highly complex contracts, M&A operations, corporate reorganisations, corporate governance, restructuring of liabilities, and general compliance. He also regularly advises pension funds and asset managers on topics related to private and public funds, mainly focusing on alternative assets. Victor graduated from Universidad del Desarrollo.

Ignacio Ruiz Rodríguez is an associate at EDN Abogados, and previously worked in the M&A and corporate practices at Alcaíno | Abogados. He has prior experience in corporate law, joint ventures and mergers and acquisitions. At EDN Abogados, Ignacio is part of the investment funds team, focusing his practice on international financial law. He graduated from Universidad de Los Andes, Chile (2020).

EDN Abogados

Avenida Apoquindo 3669
Floor 4
Las Condes
Chile

Tel: +56 233 395 430
Email: administracion@ednabogados.cl
Web: www.ednabogados.cl

Contributed by: Felipe Díaz Toro, Victor Riadi and Ignacio Ruiz Rodríguez, **EDN Abogados**

Investment Funds in Chile: An Introduction

The investment fund industry in Chile is influenced by several noteworthy trends and developments.

Flows and assets under management (AuM)

Debt funds

There has been a significant shift in net flows towards debt funds. Positive cumulative flows were recorded in 2024, in contrast to outflows in 2023. According to the Chilean Association of Mutual Fund Managers' 2024 report (the "MMFF 2024 Report"), During November 2024, the mutual fund industry recorded CLPM1,372,614 of net flows [note: CLPM = Chilean Pesos in millions], accumulating CLPM16,583,909 until November of that year, which represents 21% of the average monthly effective assets for the month, which for November 2024 reached CLPM78,056,113. Similarly, flows in series dedicated exclusively to voluntary pension savings (APV) recorded net flows of CLPM19,969 in November 2024, bringing the year-to-date total to CLPM200,411. By the end of November, assets allocated to voluntary pension savings had reached CLPM4,161,101. This growth in flows indicates increasing investor confidence, likely driven by improvements in economic indicators.

Foreign investment

The Central Bank of Chile reported foreign direct investment (FDI) figures for September 2024, which showed that in the first nine months of that year, Chile received a net flow of USD11.76 billion, an amount 5% higher than the average for the January-September period of the last two decades (since 2003).

However, between January and September 2024, accumulated FDI reached USD11.76 billion, exceeding by 5% the average of the last 20 years for this period. Meanwhile, a report by the Capital Goods Corporation (CBC) in the second quarter of this year projected that 77% of private investment in Chile by 2028 will come from foreign companies.

In addition, for the first time in history, exports of services in Chile exceeded USD2.5 billion, with an accumulated growth of 18% through November 2024, reaching USD2.518 billion. This milestone reflects progress in diversifying Chile's export portfolio, highlighting services such as aeronautical maintenance, logistics support, software development, digital animation and specialised consulting in mining and medical sciences.

The United States led as the main destination for these services, with USD839 million, followed by Peru (USD436 million) and Colombia (USD185 million), markets that together accounted for 58% of total exports.

Product developments

Structured funds

Structured investment funds have experienced notable growth, with 11 financial institutions now offering 70 different products. The MMFF 2024 Report highlights that these funds cater to low-risk preferences and have seen a steady increase in participation. Their appeal lies in their ability to offer customised risk-return profiles, often incorporating capital protection features tailored to specific investor needs. This growth underscores the demand for financial products that provide stability in volatile markets, and demonstrates the industry's innovation in addressing diverse investor appetites and risk tolerances.

Environmental, social and governance (ESG) funds

The importance of ESG considerations has grown significantly. According to the Financial Market Commission (CMF) in Chile, 40 mutual and investment funds have adopted ESG-related terms in their names, with the majority being investment funds emphasising environmental aspects. The CMF notes that the rise of ESG funds reflects increasing awareness and demand for sustainable and socially responsible investments.

Self-reported assets under management (AuM) in ESG funds range from USD900 million to USD29 billion, depending on whether the query uses a "strict" definition or an "ESG factor integration" approach. The most common investment strategies employed by these funds include "ESG factor integration", "screening", and "engagement." However, most asset management firms (AGFs) lack a formal methodology to assess whether an investment qualifies as ESG. The primary sources of information are typically provided by issuers themselves or specialised ESG rating providers.

Regulatory and self-regulatory changes

Pension System Reform

On a broader level, an important development affecting the fund industry will be the reform to the Pension Fund System approved by Chile's congress in late January 2025. This is expected to introduce significant changes to the regulatory framework governing pension fund investments, including an important increase to the system's assets under management, fewer regulatory and capital restraints for pension fund managers and a reward and punishment system for performance against a benchmark, both which should open the market for new players, governmental entities in supporting roles to private fund managers, among others. Additionally, the reform includes stricter governance requirements and enhanced transparency measures to ensure the prudent management of pension fund resources.

Taxation and fund mergers

New regulations regarding the tax treatment of mutual fund shares, fund mergers and tax exemptions have been introduced. These changes aim to preserve the tax status of investments during mergers, and to reduce or eliminate certain tax exemptions. By maintaining tax neutrality in fund mergers, the new rules promote the consolidation and efficiency of the Chilean investment fund industry, while the reduction of certain tax exemptions seeks to create a fairer tax environment across different investment types.

Investment advisory services

Proposed regulations aim to standardise investment advisory services, ensuring consistency across the industry. The MMFF 2024 Report details these proposals as efforts to enhance the quality and transparency of investment advice. By standardising advisory services, the regulations seek to protect investors and ensure the provision of accurate, unbiased and comprehensive advice. This alignment is intended to foster trust in the financial advisory industry and promote a more professional and reliable investment environment, in the context of the continued growth in popularity of investment funds.

New regulations

On 23 December 2024, the Financial Market Commission (CMF) published General Rule No 526 (NCG 526), replacing NCG No 157 of 2003. This new regulation establishes updated minimum equity and guarantee requirements for general fund and portfolio managers. It introduces differentiated criteria based on the type and volume of operations conducted by administrators, dividing them into two categories:

- Block 1: Managers with fewer than 50 non-institutional clients and without the characteristics of Block 2 are exempt from minimum equity requirements.
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The regulation introduces a more advanced methodology for calculating risk-weighted assets, accounting for operational, credit, and market risks, including specific classifications for crypto-assets. The implementation of NCG 526 will be mandatory as of 1 January 2026, while provisions related to risk management will come into effect on 1 July 2027. Managers must assess their classification and adapt their operations to meet these new regulatory standards.

On the same date, the CMF issued General Rule No 527 (NCG 527), introducing significant changes to NCG No 507 on corporate governance and risk management, as well as NCG No 468, which governs the authorisation of general fund managers' functions. This regulation includes a new section on the risk management quality assessment, allowing the CMF to evaluate the effectiveness of fund managers' controls, policies, and procedures. The assessment considers risks such as credit, market, liquidity, operational, money laundering, and conduct. Fund managers will be rated on a global scale based on their compliance, identifying areas for improvement in governance and risk management.

Additionally, NCG 527 mandates an annual risk management self-assessment, which must be approved by the board of directors and submitted to the CMF within 30 days after the end of each financial year. This self-assessment must address compliance with regulations related to organisation, internal controls, and risk mitigation.

NCG 527 applies immediately, except for the self-assessment provisions, which will become mandatory as of 1 July 2027.

Market and economic context

Exchange rate and economic stability

According to the Central Bank of Chile, inflation in 2024 exceeded earlier projections. The annual variation of the consumer price index (CPI) stood at 4.2% in November 2024 and was expected to close the year at 4.8%, fluctuating around 5% during the first half of 2025. This higher-than-expected inflation trajectory in the short term is attributed to a combination of cost pressures.

One contributing factor is the global appreciation of the US dollar, driven by heightened global uncertainty, which has increased the exchange rate. Additionally, rising local labour costs have exerted upward pressure on inflation. These shocks have occurred simultaneously, narrowing companies' operating margins and resulting in a higher pass-through to final prices than previously anticipated.

In the medium term, cost pressures are expected to ease, and the evolution of inflation will depend on domestic demand, particularly household consumption. Household consumption remained relatively flat during the second and third quarters of 2024, reflecting low job creation, the real depreciation of the Chilean peso, and persistently pessimistic expectations.

AuM and investor growth

During the first quarter of 2024, the assets under management (AuM) of public investment funds reached CLP35,753 billion, reflecting a quarterly growth of 7.5% and a 19.8% increase over the past 12 months.

According to the latest report published by ACAFI, when measured in dollars, AuM stood at USD33,894 million, representing a quarterly decline of 3.2% and an annual decrease of 3.6% compared to the first quarter of 2023. This decline was primarily attributed to the appreciation of the exchange rate, which saw annual growth of 24.3%, closing the period at 982 CLP/USD compared to 790 CLP/USD at the end of the first quarter of 2023.

The Central Bank of Chile reported that during the first three months of the year, 19 new funds were created, totalling USD100 million (CLPM98,000). However, these were surpassed in value by the liquidation of ten funds, amounting to USD107 million (CLPM105,000).

In the third quarter of 2024, the current account registered a deficit of USD3.14 billion, equivalent to 3.9% of GDP. On an annualised basis, this represented 2.7% of GDP. The deficit was driven by the negative balance in income and the services trade balance, partially offset by a surplus in the goods trade balance. Meanwhile, the financial account recorded net capital inflows of USD4.26 billion, primarily led by foreign direct investment in Chile.

Lastly, as of the end of September, the net international investment position increased its debit balance compared to the previous quarter, reaching USD64.24 billion. This movement was mainly attributed to transactions in the financial account.

Trends in alternative investments

According to the Chilean Superintendency of Pensions (SP), as of March 2024, pension funds had an average investment in alternative assets equivalent to 10.1% of the total value of the Pension System Funds. This consisted of 6.2% in effective investments and 3.9% in pledges and commitments.

Regarding the composition of current investments in alternative assets, 9% corresponded to domestic investments, while 91% were allocated internationally. The international portfolio was further divided into 66% in private equity, 18% in private debt, and 16% in infrastructure and real estate assets.

Additionally, on 11 April 2024, at the request of the SP, the structural limit for alternative asset investments was increased through Central Bank Resolution 2633-01-240411. Following this, on 15 April 2024, the Central Bank of Chile announced an expansion of investment limits for alternative assets within pension funds, creating an additional investment capacity of approximately USD6 billion. This increase, aimed at enhancing the profitability of pension funds, will be implemented gradually. The decision followed a recommendation from the Chilean Pensions Supervisor to improve fund returns, which the Central Bank has now realised.

In terms of trends in alternative investments during 2024, Dave Goodsell, Managing Director at Natixis, noted that while the environment for growth in these assets remains positive, 59% of institutional investors expressed concerns that the rising popularity of private equity is making it increasingly challenging to identify attractive opportunities. Goodsell also highlighted that within private and alternative assets, investors are primarily targeting ESG investments, with 41% focused on private equity and 39% on infrastructure, ahead of real estate and private debt.

Meanwhile, Mark Hempstead, Head of Alternative Investments EMEA at J.P. Morgan, emphasised the growing breadth of the alternative investment universe, which now includes a vast array of assets, strategies, frameworks, models, and vehicles. He noted that there are currently over 20,000 private investment funds and more than 9,000 hedge funds, with performance varying significantly, according to data from the U.S. Securities and Exchange Commission.

Hempstead further stressed that when investing in alternative assets, the first step is to establish clear objectives – whether to diversify the portfolio, mitigate volatility, protect against inflation, enhance returns, or achieve a combination of these goals.

Geopolitical trends

Regional political dynamics

South America's political landscape in 2024 has been characterised by instability, with several countries facing significant challenges. In Argentina, despite a more optimistic macroeconomic outlook following Javier Milei's election, economic crises and political unrest persisted during the first half of the year. Meanwhile, Venezuela continued to struggle with severe political and economic issues, particularly after the controversial presidential election results in July 2024. These elections secured the government's re-election for a six-year term beginning in January 2025.

The instability in the region has had spillover effects on neighbouring countries, including Chile. While Chile has maintained relative stability, the pervasive uncertainty across South America has prompted investors to seek safer options. This has led to a noticeable shift towards debt funds and low-risk financial instruments, as stability becomes a priority amidst regional volatility.

USA-China tensions

In recent years, China has expanded its influence in Latin America through closer trade, investment, and financial ties. However, according to The Economist, supported by insights from J.P. Morgan, the United States remains a key trading partner for many economies, particularly those in Mexico and Central America. As USA-China relations remain tense, Latin America finds itself navigating the influence of both powers.

Governments in the region are striving to maximise opportunities, particularly by diversifying supply chains as companies reduce dependence on China. While this trend benefits certain countries – especially those near the United States with established manufacturing-for-export industries, like Mexico – competition from low-cost Asian economies, such as Vietnam, poses challenges that limit substantial market share gains for Latin America.

That said, existing trade relations with China provide a foundation for recovery in the region following the economic recession caused by the COVID-19 pandemic. Renewed Chinese investment in Latin American infrastructure projects also offers promising medium-term prospects. However, navigating issues like 5G development presents challenges for policymakers. While the United States may increase its efforts to strengthen ties in the region, China is expected to remain a key trading and investment partner for most Latin American countries.

CHILE TRENDS AND DEVELOPMENTS

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Global trade policies

In the first eight months of 2024, Chile's trade exchange with the world rose to USD121.59 billion, reflecting a modest 0.2% increase (+USD300 million) compared to the same period in 2023. This growth was primarily driven by a surge in exports of goods.

Imports during the same period amounted to USD55.29 billion, marking a 3.7% decline (-USD2.13 billion) compared to the prior year. This decrease was primarily attributed to a 10.7% drop in capital goods (-USD1.26 billion) and a 3.1% reduction in intermediate goods (-USD973 million).

On the other hand, exports of goods reached USD66.30 billion, a 3.8% increase (+USD2.43 billion) compared to the same period in 2023. This marked the highest value of foreign sales for a comparable period since records began, showcasing Chile's strong export performance.

Macroeconomic trends

Global economic recovery

According to the World Bank, Chile's real GDP grew by 1.9% year-on-year during the first half of 2024, driven primarily by the mining sector. Gender gaps in the labour market showed mixed results: while unemployment fell to 7.9% for men, it rose to 9.0% for women. Additionally, the quality of employment deteriorated, particularly for women, as informality levels reached 26.9% for men and 29.9% for women.

Inflation, which had been on a downward trajectory, reversed course in March 2024, reaching 4.7% year-on-year by August. Real GDP growth for 2024 was projected to reach 2.5%, converging to potential levels in 2025 and 2026. However, successive electricity tariff adjustments are expected to keep inflation above 4% in the short term, with a gradual return to the 3% target by the first half of 2026.

Poverty (measured at USD6.85/day, PPP 2017) and income inequality are expected to remain at 5% and 43 Gini points in 2024, respectively, with a gradual decline anticipated in subsequent years. To boost long-term growth, reforms aimed at reducing regulatory barriers, fostering technology adoption, enhancing competition, improving education and management skills, and increasing female labour participation and job quality are vital.

Chile's economy is also poised to benefit from the green transition, thanks to its substantial renewable energy potential and abundant reserves of critical minerals such as copper and lithium – key inputs for global electrification efforts.

Interest rate policies

The Board of the Central Bank of Chile recently lowered the monetary policy interest rate by 25 basis points to 5%. This unanimous decision reflects a cautious response to global and domestic economic conditions.

Globally, the US economy has demonstrated resilience, with labour market adjustments continuing, albeit with some volatility. This has tempered market expectations regarding the Federal Reserve's rate trajectory, although uncertainty persists regarding the pace and endpoint of the federal funds rate (FFR). Fed officials have emphasised caution and gradualism in their messaging.

Meanwhile, China's economic activity remains weak, with marginal improvements in certain indicators. Broader external uncertainties, such as ongoing geopolitical tensions, fiscal instability, potential reconfigurations of global trade, and uncertainties surrounding US policy under the new government, have heightened risks. These factors have pushed long-term interest rates higher and strengthened the US dollar.

Commodities markets have also been affected. Copper prices dropped to approximately USD4 per pound due to China's economic outlook and the strengthening dollar. Oil prices have declined as well, influenced by expectations of reduced global demand and positive developments in supply dynamics.

Inflation and currency stability

Inflation continues to be a critical global challenge, influencing both investment returns and overall economic stability. In Chile, inflationary pressures have been driven by supply chain disruptions, rising commodity prices, and domestic economic factors, all of which have significantly impacted investor behaviour.

The stabilisation of the Chilean peso in early 2023, following a period of volatility, provided some relief for investors. However, inflation is anticipated to rise in the coming months, primarily due to adjustments in electricity tariffs. Since 2019, these tariffs have been set below actual costs, but a law passed in April 2024 mandates a gradual update to align tariffs with real costs. This adjustment will particularly impact inflation in 2025, with annual inflation projected to close the year at 3.6%.

According to the Central Bank of Chile, inflation is expected to converge to its 3% target by 2026. The Central Bank has reiterated its commitment to closely monitoring economic risks and taking necessary measures to ensure this convergence. Reflecting its cautious approach, monetary policy has gradually eased, leading to reduced interest rates for business and consumer loans, further supporting economic activity.

Commodity prices and economic dependence

Chile's economic outlook remains broadly balanced, but risks are increasing, according to the International Monetary Fund (IMF). Real GDP is projected to grow by 2.5% in 2025, underpinned by an anticipated recovery in domestic demand. However, inflationary pressures are expected to persist, staying above the Central Bank's 3% target until early 2026. This is largely attributed to a cumulative 60% increase in electricity tariffs between June 2024 and February 2025, alongside core inflation driven by higher transportation costs and services inflation that has proven resistant to downward adjustments.

The current account deficit is forecasted to narrow to 2.1% of GDP in 2024 but is expected to widen slightly in 2025 and 2026 as investment activity recovers. Meanwhile, the labour market remains under pressure, with elevated unemployment rates reflecting cyclical weakness in labour-intensive sectors like construction. Additional contributing factors include significant increases in real minimum wages, uncertain business prospects, and the effects of new labour market regulations.

Externally, Chile faces heightened uncertainty and instability. Volatility in commodity prices – closely tied to the economic outlooks of Chile's main trading partners and the pace of the global green transition – represents a significant risk. Furthermore, uncertainty surrounding monetary and fiscal policies in advanced economies could result in prolonged periods of tighter financial conditions and increased market volatility.

On the domestic front, challenges such as rising crime, migration, and inequality persist, compounded by political polarisation, which continues to hinder the implementation of critical reforms.

CHINA

Law and Practice

Contributed by:
Alan Du and Yiwei Shi
King & Wood Mallesons

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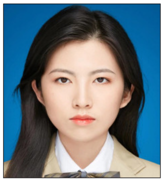
King & Wood Mallesons has its key office in Beijing and has an extensive global network of 27 international offices. The investment funds legal team of King & Wood Mallesons has in-depth local experience and has been a consistent industry leader in the establishment, investment and exiting of domestic and overseas funds. The firm's lawyers and experts have proficiency in laws, policies and regulations, both at home and abroad, and are capable of advising clients on various private equity funds, on drafting investment plans and on designing investment structures. King & Wood Mallesons also has lawyers who focus on tax, intellectual property, labour, real estate and insurance law, enabling them to offer professional one-stop support in investment funds projects at any time.

Authors

Alan Du is a partner in King & Wood Mallesons' Shanghai office, and specialises in fund formation, foreign direct investment, M&A, and the utilisation of assets of insurance institutions. In the area of Chinese renminbi fund formation, Mr Du has advised institutions such as Macquarie Capital, Baring, Asia Alternatives, Nomura, CPIC, China Taiping Insurance, DT Capital, SIG, Guosheng Group, BOCGI, Ping An, ICBC-AXA, Abax, Greenwoods, Shanghai Electric and Shanghai STVC, covering all pertinent aspects of fund formation and tax planning.



Yiwei Shi is an associate in King & Wood Mallesons' Shanghai office, specialising in fund formation, fund manager registration and the utilisation of insurance institutions' assets. She has assisted several clients in completing fund formation and fund manager registration, and has assisted numerous insurance institutions with investment in private equity funds.

King & Wood Mallesons

17th Floor, One ICC, Shanghai ICC
999 Middle Huai Hai Road, Xuhui District
Shanghai 200031
People's Republic of China

Tel: +86 212 412 6037
Fax: +86 212 412 6150
Email: duhonghui@cn.kwm.com
Web: www.kwm.com

金杜律师事务所
KING&WOOD
MALLESONS

Contributed by: Alan Du and Yiwei Shi, **King & Wood Mallesons**

1. Market Overview

1.1 State of the Market

In the People's Republic of China (PRC), investment funds are generally divided into two categories: public funds and private funds.

Public Funds

Subject to approval by the China Securities Regulatory Commission (CSRC), public funds may be marketed through public means (such as public media) towards the general public, including those who are not Qualified Investors (as further explained in **2.2.3 Restrictions on Investors**). Public funds may be considered the Chinese equivalent of retail funds.

According to the latest statistics published by the Asset Management Association of China (AMAC), as of 31 October 2024, the assets under management of 12,212 public funds reached CNY31.50 trillion.

Private Funds

Private funds can only be marketed to Qualified Investors by way of a private placement. Private funds may be considered the Chinese equivalent of wholesale funds or alternative investment funds.

According to the AMAC, as of 31 October 2024 there were 20,411 private fund managers registered with it, and the assets under management of 147,037 private funds that filed with the AMAC stood at CNY19.93 trillion.

Funds Market in 2024

The growth of public funds has exceeded that of the previous two years, and has returned to the level of 2021. From January 2024 to October 2024, public funds increased from CNY27.36 trillion to CNY31.50 trillion – an increase of CNY4.14 trillion. This was higher than in 2023 (an increase of only CNY0.13 trillion), in 2022 (an increase of only CNY0.67 trillion) and in 2021 (an increase of CNY3.81 trillion). However, the number and the size of private securities investment funds slightly decreased in 2024. From January 2024 to October 2024, the number of private securities investment funds decreased from 97,571 to 90,853. At the same time, private securities investment funds decreased from CNY5.52 trillion to CNY5.25 trillion – a decrease of CNY0.27 trillion.

There was also a small decline in the private equity funds industry. From January 2024 to October 2024, the number of private equity funds decreased from 55,409 to 55,259. At the same time, private equity funds decreased from CNY14.32 trillion to CNY14.27 trillion – a decrease of CNY0.05 trillion.

Further, fundraising has become increasingly challenging for fund managers, and the polarised situation of the fundraising market has become more pronounced. Regrettably, even top-tier private equity fund managers have slowed their fundraising pace compared to 2023. State-owned capital is increasingly becoming a significant contributor to private equity funds, and investors with SOE backgrounds have become a main force in the private equity investment market. Both the number and size of new funds in the first three quarters of 2024 decreased significantly compared to the same period the previous year. By September 2024, the number of new private funds was 7,787, while in 2023, the number was 20,056. At the same time, the size of new private funds was CNY282.8 billion, while in 2023 the size was CNY538.8 billion.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Most private funds in the PRC are structured as limited partnerships or contractual funds. Although funds can be formed as limited companies, in practice limited company funds are relatively rare because they are generally less tax-efficient, and the PRC's Company Law does not support the concept of a "management share", as is available in some other jurisdictions and which gives the holder of a management share similar powers to a general partner.

Private Securities Investment Funds

Private securities investment funds typically take the form of a contractual fund. The main competitive advantages that a contractual fund has over a limited partnership are as follows.

- A contractual fund can have up to 200 investors, whereas a limited partnership only allows up to 50 partners.
- A contractual fund is not a legal entity that needs to be registered with the enterprise registration authority, the Administration for Market Regulation (AMR). Therefore, its subscription and redemption processes are more efficient, without needing to go through the registration process.
- The fund manager of a contractual fund does not withhold the income tax for individual investors as a matter of general practice, whereas a limited partnership fund must withhold income tax for individual investors.

Private Equity Funds

Limited partnership

In the PRC, most private equity funds are structured as limited partnerships, for the following reasons.

- The PRC's Partnership Law is flexible, and a limited partnership fund can accommodate most of the international practice of private equity funds.
- In examining a company looking to launch an IPO, the CSRC generally treats a shareholder in the form of a contractual fund as problematic as it is hard to trace the beneficial owners behind the contractual fund. Therefore, a fund with a strategy of exiting from its portfolio companies by way of an IPO will be formed as a limited partnership, instead of as a contractual fund.

Contractual fund

Due to the difficulties of listing real estate companies or assets in China, a real estate fund's exit strategy usually excludes an IPO or securitisation, and therefore it may be formed as a contractual fund.

Limited company

Some of the funds funded by state-owned enterprises (SOEs) may use the form of a limited company. The PRC's Partnership Law provides that an SOE shall not act as the general partner; but, in practice, an SOE under the Partnership Law is interpreted in a narrow way – eg, the subsidiary of an SOE may be exempted. However, some SOEs may still prefer a fund in the form of a limited company, where no SOE will need to act as the general partner.

Fund managers

Most private fund managers are structured as limited companies, though some may be structured as limited partnerships.

2.1.2 Common Process for Setting Up Investment Funds

Establishing a Legal Entity and Registering It With the AMAC as a Private Fund Manager

The form of a legal entity as a limited company or limited partnership must first be established. The name of such entity must include "private fund", "private fund management" or "venture capital investment", and the business scope of such entity must include "private funds management", "private securities investment funds management", "private equity funds management" or "venture capital funds management" and other words reflecting the characteristics of the private equity fund it intends to manage.

The timeline depends on the location where the entity is established, and may vary from one month to six months, or even longer. Some local governments set high standards for accepting the establishment of such entities, which makes it extremely difficult to complete such establishment. The entity should apply to the AMAC for registration as a private fund manager within 12 months from the date of establishment, except in cases where registration needs to be deferred due to changes in policies of the relevant state departments, etc. To register the legal entity with the AMAC as a fund manager, a legal opinion must be issued by a qualified PRC law firm on whether the applicant has fulfilled the AMAC's requirements regarding the applicant's:

- name;
- business scope;
- number of employees;
- capital contributions; and
- relevant investment experience of its officers, etc.

It usually takes three to four months to complete registration with the AMAC, but there is no guarantee of this timeframe. The AMAC retains much discretion, and an applicant satisfying all the written requirements may still fail to complete registration due to inconsistency with the AMAC's internal principles or otherwise.

Establishing a Fund Vehicle

For private equity funds, the fund vehicle, usually in the form of a limited partnership with a business scope containing equity investment, may be established before the first closing of the fund, so that the fund vehicle may admit investors upon first closing. Again, the timeline depends on the location where the entity is established, and may vary from one month to six months, or even longer. Some local governments set high standards for accepting the establishment of such fund vehicles, which makes it extremely difficult to complete such establishment.

Fundraising

The timeline for the fundraising process depends on various commercial factors, and is subject to various requirements regarding marketing of the fund, risk disclosure, verification of Qualified Investors, etc.

Fund-Filing With the AMAC

After the first closing and first instalment of the capital contribution, the fund is filed with the AMAC by the fund manager, and the process may take one to two months.

2.1.3 Limited Liability

Regarding the debt of private funds, investors shall generally be protected by limited liability, as follows.

Limited Partnership Funds

Limited partners shall be liable for the debt of the limited partnership fund to the extent of their subscribed capital – ie, their capital commitment.

Contractual Funds

Though a contractual fund, as a legal form, is frequently used for setting up most private securities investment funds, and occasionally for private equity funds, there is essentially no explicit law dealing with contractual funds.

According to the Securities Investment Fund Law, investors of public funds and private securities investment funds shall only be liable for the debt of the fund to the extent of their investments, which is read as applicable to a private securities investment fund in the form of a contractual fund. Also, the authors tend to believe that such limited liability protection shall apply to investors of a private equity fund in the form of a contractual fund.

Limited Company Funds

For a fund in the form of a limited company, investors (ie, shareholders) are liable to the extent of their subscribed capital.

2.1.4 Disclosure Requirements

In the PRC, private funds are subject to ongoing disclosure obligations.

Fundraising Information Disclosure

Marketing documents such as the private placement memorandum must include basic information on:

- the fund and the manager;
- custody arrangements (if any):
- investment of the fund;
- distribution of proceeds; and
- performance fee arrangements, etc.

The content of these should be substantially the same as the fund contracts. In addition, a risk disclosure document is required to be signed by investors as a filing document, which must fully disclose various risks of the fund.

Fund Operation Information Disclosure

Periodic reporting obligation

The content and frequency of disclosure requirements differ according to the type of fund. For private securities investment funds, monthly reports must be submitted to the AMAC, disclosing information on the fund size, unit net value and investors. However, private equity funds are only required to report quarterly in respect of the net asset value, and key financial and investment information.

Disclosure requirement on specific events

When certain events occur, disclosures are required to be made to investors in a timely fashion. According to the AMAC's rules, such events would normally have a significant impact on investors' interest, including:

- change of investment scope of the fund;
- change of the fund manager or the custodian; and
- significant related-party transactions.

Consequences of failure to fulfil disclosure requirements

The AMAC conducts inspections on fund information disclosure from time to time and may take disciplinary actions against the responsible person, depending on the seriousness of the case.

If a private fund manager fails to submit periodic reports in a timely manner, the AMAC may suspend the fund manager's application for filing a new fund until such obligation is fulfilled.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

In the PRC, private funds can only be marketed to Qualified Investors, which includes individual investors and institutional investors.

The authors see increasingly more individual investors investing in private securities investment funds, and more institutional investors (ie, corporate investors, SOEs, government guiding funds, insurance companies, etc) investing in private equity funds. Institutional investors also have different preferences depending on their type. For example, insurance companies would normally invest in funds established by top-tier fund managers, and corporate investors tend to invest in specific industrial funds for synergy with their own business.

2.2.2 Legal Structures Used by Fund Managers

Fund Managers

In the PRC, private fund managers are typically structured as limited companies, and some take the form of limited partnerships.

Fund Structures

For limited partnership funds, fund managers usually also serve as general partners, but there is a trend of separation of the fund manager and the general partner, who is often a subsidiary of the fund manager.

For contractual funds, parties to the fund contract include investors, the fund manager and the custodian.

For limited company funds, a separate fund manager may or may not be one of the shareholders of the fund. Also, it is possible for a limited company to have an internal fund management team without a separate fund manager.

2.2.3 Restrictions on Investors

Private funds can only be invested in by Qualified Investors.

Qualified Investors are those institutions and individuals who invest an amount of not less than CNY1 million in a single private fund, and accord with the following standards:

- with respect to institutions, their net assets must be no less than CNY10 million; or
- with respect to individuals, their financial assets (such as bank deposits, stocks and bonds) must be no less than CNY3 million, or their personal average annual income in the last three years must be no less than CNY500,000.

Where an investor has no legal personality (such as partnerships and contracts), such investor shall be looked through to verify whether those investors holding interests in such investor are Qualified Investors, with the exemptions applicable to certain investors, including:

- social welfare funds;
- private funds;
- bank asset management products;
- Qualified Foreign Institutional Investors (QFIIs) and Renminbi Qualified Foreign Institutional Investors (RQFIIs) approved by the CSRC; and
- private fund managers and their employees who invest in the private funds under their management.

These shall be regarded as Qualified Investors and are not subject to the above “look-through” rules. QFIIs and RQFIIs refer to foreign institutional investors that have been approved by the CSRC to make securities and futures investments in the PRC with offshore funds, including overseas fund management companies, commercial banks, insurance companies and securities companies.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

In general, the CSRC is the regulator of the listed securities and futures market, and also supervises and administers the private funds market. Under the supervision of the CSRC, the AMAC is a self-disciplinary organisation, but the authors tend to believe that it is also the de facto regulator of the private funds industry. It has issued a set of self-disciplinary rules on the registration of private fund managers, the filing of private funds, disclosure requirements, etc.

In 2014, the CSRC promulgated the Interim Measures for the Supervision and Administration of Private Investment Funds, which provide a general regulatory regime for the private funds industry. The AMAC subsequently released a series of detailed rules.

In January 2021, the CSRC promulgated the Provisions on Strengthening the Supervision of Private Funds (the “Private Funds Provisions”), which outline the latest regulatory framework regarding private funds. In June 2022, the AMAC promulgated the new List of Requirements for Private Fund Manager Registration, the Key Points of Private Equity Fund Filing and the Key Points of Private Securities Investment Fund Filing, stipulating the latest regulations regarding fund manager registration and the filing of private funds.

In February 2023, the AMAC promulgated the Measures for Registration and Filing of Private Investment Funds (effective on 1 May 2023), further summarising, revising and highlighting regulations regarding fund manager registration and the filing of private funds.

In July 2023, the State Council issued the Regulation on Supervision and Administration of Private Investment Funds (effective on 1 September 2023 (the “Regulation”)). The Regulation essentially follows and emphasises the pre-existing rules, but the authority of the Regulation is higher than those rules issued by the CSRC and AMAC. In September 2023, the AMAC released a series of detailed new rules regarding the filing of private funds (see **4.1 Recent Developments and Proposals for Reform**).

In April 2024, the AMAC promulgated the Guideline for Operation of Private Securities Investment Funds (effective on 1 August 2024), raising the operational requirements for private securities investment funds, and protecting the legitimate rights and interests of investors.

Under the preceding regulations, private funds are not permitted to directly or indirectly make investments that are prohibited or restricted by the government, or that are inconsistent with national industrial policies, environmental protection policies or land administration policies, with the exception of investments in listed securities. Investing in loans (including disguised loans) and providing guarantees are also prohibited by the AMAC. However, for the purpose of equity investment, if the borrowing or guarantee period is less than one year, private equity funds may provide loans or guarantees to portfolio companies. In addition, private funds may not invest in credit assets such as factoring assets, financial leasing assets or pawn assets, nor make investments that have unlimited liability.

2.3.2 Requirements for Non-Local Service Providers

Generally, only local service providers are allowed to provide services in China to private funds.

For non-local service providers providing services outside China to Chinese private funds/ fund managers, PRC law is silent regarding the regulation of registration requirements, etc. Considering a Chinese fund is unlikely to have an offshore account or other offshore operations, it seems unlikely that a Chinese fund would engage a non-local custodian or administrator.

2.3.3 Local Regulatory Requirements for Non-Local Managers

Only fund managers that have been duly registered with the AMAC are permitted to manage private funds in China. No regulatory requirements are expressly applicable to non-local managers of private funds. A non-local manager's marketing activities in China for their offshore funds are not clearly dealt with by PRC law, and professional advice should be sought before conducting such activities.

2.3.4 Regulatory Approval Process

See **2.1.2 Common Process for Setting Up Investment Funds.**

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

There is no clear definition of pre-marketing under PRC law. With reference to the EU's definition, pre-marketing activities may be understood as including provision of information on investment strategies or investment ideas on behalf of a private fund manager to qualified investors, and testing investors' interest in a private fund before the commencement of fundraising, but without providing such information as contained in the fund marketing documents (see **2.1.4 Disclosure Requirements**).

For the provision of information on investment strategies or investment ideas, the Measures for the Administration of the Fundraising of Private Investment Funds (the "Fundraising Measures") expressly allow private fund managers to market their investment strategies through legitimate and public means, indicating a relaxed attitude towards regulating such activities.

PRC law is silent on the testing of investors' interest in a private fund, but before such testing it is advisable to complete the following:

- determination of specified investors; and
- suitability matching (see **2.3.10 Investor Protection Rules**).

2.3.6 Rules Concerning Marketing of Alternative Funds

In general, the marketing of private funds is regulated by:

- the Securities Investment Fund Law;
- the Fundraising Measures;
- the Measures for the Administration of the Appropriateness of Securities and Futures Investors promulgated by the CSRC (the "Appropriateness Measures"); and
- the Private Funds Provisions.

Public Offering Should Be Avoided During Private Fund Marketing

In the PRC, approval is required for marketing to the general public. According to the Securities Investment Fund Law, raising funds from non-specific targets or issuing securities to more than 200 specific targets accumulatively in the PRC will be regarded as a public offering and should be subject to the CSRC's approval.

Private fund managers and placement agents must not disseminate information to non-specific targets via public communications media (such as newspapers, radio stations, TV or the internet) or through lectures, seminars, analysis meetings, bulletins, leaflets, short messages, blogs, emails or other means. However, marketing through an official website or the internet with a mechanism that is only accessible to specific targets is not considered a public offering.

Restrictions on Content of the Presentation

Certain content is strictly forbidden to be used when marketing, including:

- direct or indirect promises to investors that there will be no losses of the investors' funds, or that there will be a minimum income; or
- using exaggerated words, such as "safe", "promise", "secure", "avoidance of risks", "guaranteed", "high income" or "no risk".

2.3.7 Marketing of Alternative Funds

Private funds can only be marketed to Qualified Investors.

2.3.8 Marketing Authorisation/Notification Process

Under PRC law, authorisation or notification is not required by the national regulator for marketing private funds.

2.3.9 Post-Marketing Ongoing Requirements

Private fund managers who have marketed and closed a private fund must perform the following duties:

- fund filing with the AMAC (see **2.1.2 Common Process for Setting Up Investment Funds**);
- information disclosure (see **2.1.4 Disclosure Requirements**); and
- periodic reporting obligation (see **2.1.4 Disclosure Requirements**).

2.3.10 Investor Protection Rules

Special Protection for General Investors

Qualified Investors that may invest in private funds are broadly split into general investors and professional investors.

General investors can be further classified into five types (C1 to C5), based on their risk tolerances. Special protections will be provided to general investors with respect to information disclosures, risk warnings, suitability matching, etc. For example, fundraisers may not actively conduct marketing of a fund to general investors whose tolerance is lower than the risk level of the fund. Investors who belong to the lowest risk tolerance category are not allowed to invest in any fund with a risk rating above their risk tolerance. However, investors may invest in relatively riskier funds after accepting special risk warnings that are issued by fundraisers in writing.

Fair Treatment to Investors

Under the Private Funds Provisions, all investors of a private fund must receive fair treatment.

Regulatory Reporting Requirements

As well as submitting periodic reports to the AMAC (see **2.1.4 Disclosure Requirements**), private fund managers must also disclose fund operation information to investors, and must submit information disclosure reports to an AMAC online system for records. While private securities investment fund managers should issue an information disclosure report to investors monthly, quarterly and annually, private equity fund managers are only required to submit semi-annual disclosure reports and an annual disclosure report. As mentioned in **2.1.4 Disclosure Requirements**, when certain events occur, private fund managers are required to report to the AMAC within ten business days and to make a disclosure to investors. In accordance with the AMAC's rule, significant matters specifically include:

- change of the fund manager and the custodian;
- major changes to the fund contract;
- change of type of private fund;
- change of fund service institutions; and
- other events that may have a significant impact on the continued operation of the fund, the interests of investors or the net asset value of the fund.

2.3.11 Approach of the Regulator

The AMAC accepts telephone enquiries as well as email enquiries regarding the relevant regulations and compliance requirements. Face-to-face meetings are generally not available.

2.4 Operational Requirements

Restrictions on Investments in Private Funds

In general, private funds are not permitted to directly or indirectly make investments that are prohibited or restricted by the government, or that are inconsistent with national industrial policies, environmental protection policies or land administration policies, except for an investment in listed securities.

Private securities investment funds

For private securities investment funds, investment is limited to:

- listed stocks;
- bonds;
- futures;
- options;
- other securities investment funds; and
- other assets recognised by the CSRC.

Private equity funds

Private equity funds must mainly invest in unlisted equity; investing in loans and other fixed-income investments has generally been banned by the AMAC, which holds the general view that any investment looking for fixed income cannot be the investment target of private funds. Specifically, private funds are not permitted to directly or indirectly make investments that are prohibited or restricted by the government, or that are inconsistent with national industrial policies, environmental protection policies or land administration policies, except for an investment in listed securities.

Investing in loans (including disguised loans) and offering guarantees is also prohibited by the AMAC. However, for the purpose of equity investment, if the borrowing or guarantee period is less than one year, private equity funds may provide loans or guarantees to portfolio companies, except for a real estate pilot fund, which may provide loans or guarantees to portfolio companies without limitations on the period. In addition, private funds may not invest in credit assets such as factoring assets, financial leasing assets or pawn assets, nor make investments that have unlimited liability.

Asset Protection

In general, unless otherwise agreed in the funds contracts of certain funds satisfying AMAC criteria, private funds may have fund custodians. Where there is no custodian, the funds contract should explicitly provide measures to protect fund assets and a dispute resolution mechanism. In practice, the majority of private funds have custodians.

In addition, in line with investor protection, where private funds conduct related-party transactions (ie, transactions that involve the private fund, the fund manager, investors, other private funds managed by the manager or under the same actual controller, or other related parties that have significant interests with these subjects), effective risk-control mechanisms such as disclosure arrangements and special decision-making procedures for related-party transactions must be established.

Other Specific Requirements

Borrowing restrictions

According to the Private Fund Provisions, private funds are generally banned from providing loans or guarantees; but for the purpose of equity investment, if the borrowing or guarantee period is less than one year, private equity funds may provide loans or guarantees for portfolio companies, except for a real estate pilot fund, which may provide loans or guarantees to portfolio companies without limitations on the period. Despite the foregoing, the expiry date of the term of borrowing or guarantee must be no later than the end of the investment, and the amount of borrowing or guarantee must not exceed 20% of the total assets of the private fund, except for more lenient restrictions for a real estate pilot fund.

Valuation of fund assets

The AMAC has published fund valuation guidelines, which are not compulsory, and provides comprehensive guidance on the valuation of fund investment targets, including stocks, restricted shares, fixed-income instruments and unlisted equity. However, because it is not compulsory, most fund managers do not use the guidelines.

Restrictions on related-party transactions

According to the Private Fund Provisions, private fund managers must not conduct related-party transactions that may cause loss of fund assets or violate the interests of investors. Private fund managers should establish mechanisms regulating related-party transactions, such as a pricing policy in relation to related-party transactions and a transaction approval system. Related-party transactions that involve fund assets must acquire pre-approvals from investors through the agreement mechanism, and must be fully disclosed to investors after the investment.

Prohibition on insider dealing and market abuse

Insider dealing, manipulating a securities and futures market, and other market abuse conduct are forbidden under the Private Fund Provisions. Violations of these rules are subject to strict administrative measures by the CSRC, and the violator shall be publicised through the capital market integrity information database. Also, criminal penalties may be imposed if the relevant conduct constitutes an offence under criminal laws.

2.5 Fund Finance

In general, private funds in the PRC are permitted to borrow for making investments. For example, private equity funds may access M&A loans, in which commercial banks can provide loans of up to 60% of the transaction price, and the borrower must provide sufficient security for the debt.

Restrictions on Borrowings

According to the Guiding Opinions on Regulating the Asset Management Business of Financial Institutions (the “Guiding Opinions”), the leverage ratio of an asset management product must be limited, and the total assets of a private product must not exceed 200% of its net assets, which means the borrowing must not exceed 100% of the capital. For graded products (products with preferred unit holders receiving distributions prior to other unit holders), the total assets must not exceed 140% of the net assets.

The Guiding Opinions do not directly apply to private funds, and the AMAC has indicated that it would issue a detailed rule applicable to private funds in accordance with the Guiding Opinions. However, such a rule has not yet been published, and it is advisable to follow the restrictions of the Guiding Opinions.

In practice, it is not common for private equity funds to borrow to make investments. Additionally, fund contracts may also set restrictions such as prior approval on each borrowing.

Security for Borrowing

In the PRC, it is common for banks to take collaterals such as real property or marketable securities, or to seek a guarantee from guarantors with capability of repayment. Sometimes, the fund manager or its affiliate may provide a bridge loan or warehousing to a fund without security.

2.6 Tax Regime

The applicable tax regime for private funds depends on the form of the fund and the type of income.

Limited Company Funds

A limited company fund itself is subject to enterprise income tax (EIT) at the rate of 25%.

Income tax also applies to investors, depending on the investor type:

- limited company investors are generally subject to a 25% EIT on their own profit, but dividends from the limited company fund may be exempted to avoid double taxation after the limited company fund has paid its EIT; and
- for individual investors, a 20% individual income tax (IIT) shall apply.

Limited Partnership Funds

Private funds structured as limited partnerships are tax-transparent for income tax, and for investors of such funds the tax treatments are as follows.

For individual investors, due to the absence of clear tax law, the practice varies between different locations of China. Ideally, a flat rate of 20% IIT shall apply, but in some locations, a progressive rate from 5% to 35% shall apply.

For a limited company investor, a 25% EIT applies to its profits. Though dividends received by a company from another company shall be exempted, uncertainty exists regarding the eligibility of the dividends paid by a portfolio company indirectly through a limited partnership fund to its limited company investors, which can be interpreted as distribution from the limited partnership, instead of dividends from the portfolio company. The practice may vary between different locations of China.

Contractual Funds

As with limited partnership funds, contractual funds are also tax-transparent.

Similar to the practice of investment trust companies in China for the IIT of individual investors regarding investment trusts under their management, the fund manager does not withhold the IIT for individual investors, and each individual investor shall be responsible for their own tax declaration.

A limited company investor is subject to a 25% EIT on its profits, except for dividends received from another company.

Preferential Tax Policy for Venture Capital Funds

An additional preferential tax policy may apply to venture capital funds investing in scientific and technological enterprises that meet certain requirements.

For a venture capital fund structured as a limited company, where the fund has directly invested in an eligible scientific and technological enterprise for more than two years, it can have a tax credit at 70% of the investment amount against the EIT. If the amount of the granted tax credit is not fully used, that balance can be carried forward to the following tax year.

For a venture capital fund structured as a limited partnership, a similar policy applies to the investors of the fund. Namely, a limited company investor can claim a tax credit of 70% of the investment amount in the eligible scientific and technological enterprise against its income from the fund. An individual investor can have the same amount of tax credit against its income from the fund.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

The law is unclear about the form of public funds – eg, a limited partnership, a trust or otherwise.

Under the Securities Investment Fund Law:

- a public fund is not a legal entity;
- the fund manager is entrusted to manage the assets of the public fund; and
- the assets of the fund are separate from the assets of the fund manager.

For those issues that the Securities Investment Fund Law does not provide for, the PRC Trust Law shall apply. Therefore, the authors tend to believe that the form of a public fund should be similar to a trust.

Investors' interests in a public fund are called fund units.

Public funds can be operated as open-ended or closed-ended. After the first open-ended public fund was approved in 2001, open-ended public funds have become the most popular form of public fund. As of October 2024, there were 10,833 open-ended public funds, whereas the number of closed-ended public funds was 1,342.

As a public fund is not a legal entity, the subscription or redemption of fund units will not trigger the registration process with the AMR, which suits the operation of open-ended public funds.

Based on the list of public fund managers publicised by the AMAC, public fund managers are all structured as limited companies in the PRC.

3.1.2 Common Process for Setting Up Investment Funds

The common process for setting up a public fund in the PRC includes the following steps.

Setting Up a Public Fund Manager

A public fund manager can be set up by doing the following.

- Establishing a new public fund management company.
- Obtaining a public fund manager licence for an existing asset management institution, such as for:
  - (a) asset management subsidiaries of securities companies;

(b) insurance asset management companies;
(c) wealth management subsidiaries of commercial banks; or
(d) private securities investment fund managers.

In May 2022, the CSRC released Measures for Supervision and Administration of Public Securities Investment Fund Managers (effective on 20 June 2022) and supplementing rules, which impose stricter requirements for setting up a public fund manager (such as a higher requirement regarding financial status of the major shareholders of a newly established public fund manager).

Setting up a new public fund management company

To set up a public fund management company, approval of the CSRC must first be obtained after satisfying various strict requirements. High-standard requirements also apply to the company's major shareholders in respect of their registered capital, net asset scales, etc.

After the submission of the application documents, the CSRC may require the applicant to supplement the documents before it accepts the application. Once the application documents are accepted, the CSRC shall decide whether to issue the approval within six months. In practice, it is hard to obtain approval from the CSRC, which determines whether to grant the approval on a discretionary basis. Therefore, the actual time for obtaining approval is uncertain, depending on the background of the prospective shareholders of the fund manager, etc.

Within 30 days of receipt of the CSRC's approval, the applicant must register the fund management company with the AMR. The new fund management company is established upon the issuance of a business licence by the AMR.

After the establishment of the fund management company, the company must prepare for operation by satisfying various requirements regarding its office, IT system, employees, etc, to be inspected by the CSRC. The preparation period may last as long as six months or so. The public fund management company may only start business operations after passing the inspection by the CSRC.

Public fund manager licence for existing institutions

Subject to certain conditions, asset management institutions (such as asset management subsidiaries of securities companies and insurance asset management companies, wealth management subsidiaries of commercial banks, or private securities investment fund managers) can also apply for the public fund manager licence from the CSRC.

In general, an applicant must fulfil the following conditions:

- at least three years' management experience of securities assets with good performance;
- sound corporate governance, with a sophisticated internal mechanism and effective risk-control system;
- good business performance and financial standing for the last three years;
- no significant violation of the applicable laws and regulations; and
- the number of employees who have obtained the qualification for fund practice must not be less than 30 in principle.

Other requirements include a minimum scale of assets under management, construction of information systems, and so on.

After submission of the application documents, the CSRC may require the applicant to supplement the documents before it accepts the application. Once the application documents are accepted, the CSRC shall decide whether to issue the approval within 20 business days, which may be extended to 30 business days subject to the CSRC's internal approval. For similar reasons, the actual time for obtaining the approval is uncertain.

After the application is approved, the applicant must further prepare for public fund management business by satisfying various requirements, such as setting up a specific department for fund business and the establishment of a fund investment decision-making process, to be inspected by the CSRC. The preparation period may last as long as six months or so. The public fund management company may only start public fund management business after passing the inspection by the CSRC.

Fund registration with the CSRC

A licensed public fund manager may market and raise public funds subject to the relevant requirements.

A prospective public fund must be registered with the CSRC before being marketed to the general public. In general, a public fund to be marketed should have a specific investment direction, and the name must indicate its type and features. The application documents for fund registration generally include:

- an application report;
- a draft fund contract;
- a draft custody contract;
- a draft prospectus; and
- a legal opinion issued by a PRC law firm.

The CSRC may require the applicant to supplement the documents before it accepts the application for registration of a new public fund. Once the application documents are accepted, the CSRC shall decide whether the public fund can be registered for fundraising within six months. In practice, some public funds may complete registration within one month.

Fundraising and filing with the CSRC

The fundraising period must not exceed three months from the date of offering. Upon the expiry of the fundraising period, the manager must engage an accounting firm to conduct capital verification for the fund and file the public fund with the CSRC, which will grant a written confirmation within three business days.

3.1.3 Limited Liability

Regarding the debt of public funds, investors are protected by limited liability and only bear the risks to the extent of their investment in the fund.

3.1.4 Disclosure Requirements

In general, public fund managers and custodians must disclose fund information to investors and publicise fund operation information via newspapers and websites recognised by the CSRC.

Specifically, the following information must be disclosed:

- the prospectus, the fund contract and the fund custody agreement;
- the fundraising information;
- the announcement on the listed fund units;
- the net asset value of the fund and fund units;
- the subscription and redemption prices;

- the quarterly reports, semi-annual reports and annual fund reports;
- interim reports;
- the resolutions of the fund unit-holders' meeting;
- major personnel changes of the fund custodian or manager;
- legal proceedings or arbitration related to fund assets, the fund management or the fund custody; and
- other information to be disclosed as required by the CSRC.

False records, misleading statements or material omissions, predictions of investment performance and promises regarding income are strictly prohibited.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

Subject to fund marketing rules, including the Appropriateness Measures, public funds may be offered to the general public.

Based on their investment scope (as further explained in **3.3.1 Regulatory Regime**), public funds can be classified as:

- share investment funds;
- bond funds;
- money market funds;
- hybrid funds; and
- funds of funds.

Except for low-risk money market funds (which are the most popular for both individual and institutional investors), institutional investors generally prefer bond funds, while individual investors generally prefer hybrid funds (ie, funds that can invest in shares, bonds or other funds) and share investment funds.

3.2.2 Legal Structures Used by Fund Managers

Based on the list of public fund managers publicised by the AMAC, public fund managers are all structured as limited companies in the PRC.

3.2.3 Restrictions on Investors

The Appropriateness Measures also apply to public funds. As previously mentioned, investors are split into general investors and professional investors, and general investors can be further classified into five types (C1 to C5), based on their risk tolerances. Fundraisers may not market a fund to any investor whose risk tolerance is lower than the risk level of the fund without solicitation of the investor. Investors of the lowest risk-tolerance category shall not be accepted to invest in any fund with a risk rating above their risk tolerance unless a special risk warning in writing has been provided.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

The Securities Investment Fund Law is the basic law regarding the regulation of retail funds. The CSRC, as the regulator of the public fund industry, has accordingly promulgated a series of regulations in relation to the establishment of a fund management company, fund registration, and the operation and management of public funds.

A public fund may only invest in listed securities, futures and derivatives, depending on the type of the fund. Except for hybrid funds (ie, funds that can invest in shares, bonds or other funds), the limitations on different types of public funds are as follows:

- for share investment funds, 80% or more of the fund assets must be invested in stocks;
- for bond funds, 80% or more of the assets must be invested in bonds;

- for money market funds, all assets must be invested in money market instruments; and
- for funds of funds, 80% or more of the assets must be invested in other funds.

In addition, public funds are subject to certain restrictions with respect to the proportion of the investment. For example, for each public fund, the value of securities of a single company held by the fund must not exceed 10% of the fund's net asset value.

3.3.2 Requirements for Non-Local Service Providers

Generally, only local service providers are allowed to provide services in China to public funds.

For non-local service providers providing services outside China to Chinese public funds/fund managers, under Shanghai-Hong Kong Stock Connect (a cross-boundary investment scheme that connects the Shanghai Stock Exchange and the Hong Kong Stock Exchange), Chinese fund managers are permitted to engage Hong Kong entities to provide investment advisory services such as issuance of a research report on southbound trading (ie, domestic investors in China investing in securities listed in Hong Kong). A Hong Kong entity providing investment advisory services must comply with the relevant provisions under PRC law and Hong Kong law.

In general, the Hong Kong service provider must have obtained the licence on providing investment advice from the Hong Kong regulatory authority, the Securities and Futures Commission (SFC). Where a Chinese public fund manager is provided with such services, it must file documents – including the service agreement, an undertaking letter issued by the Hong Kong service provider and relevant certificates – with the CSRC.

Except for the above, the law is silent regarding the registration requirements for other non-local service providers. Considering a Chinese public fund is unlikely to have an offshore account or other offshore operations, etc, it seems unlikely that a Chinese fund would engage a non-local custodian or administrator.

3.3.3 Local Regulatory Requirements for Non-Local Managers

As mentioned in **3.1.2 Common Process for Setting Up Investment Funds**, only fund management companies and asset management institutions that have been approved by the CSRC are permitted to manage public funds in China.

For non-local managers' marketing activities in China for their offshore funds, according to the Interim Provisions on the Administration of Recognised Hong Kong Funds (the "Hong Kong Funds Provisions"), Hong Kong public funds – including unit trusts, mutual funds and other collective investment schemes – may be marketed to the general public in China after registration with the CSRC. The registration is subject to strict conditions regarding the fund and the fund manager. For example, the Hong Kong fund must be established and operated in compliance with Hong Kong law, and must be approved to have a public offering and be regulated by the SFC. Also, the Hong Kong fund manager must be registered in Hong Kong and licensed to conduct asset management.

In addition, a prospective Hong Kong fund manager must engage a Chinese public fund manager or a custodian approved by the CSRC as its local representative.

3.3.4 Regulatory Approval Process

See **3.1.2 Common Process for Setting Up Investment Funds**.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Under PRC law, there is no clear definition of pre-marketing. With reference to the EU's definition, pre-marketing activities may be understood as including provision of information on investment strategies or investment ideas on behalf of a public fund manager to investors, and testing investors' interest in a public fund before the commencement of fundraising, but without providing such information as contained in the fund marketing documents (see **3.3.6 Rules Concerning Marketing of Retail Funds**).

Currently, PRC law is silent on pre-marketing activities, but it is advisable to conduct the risk assessment and suitability-matching procedure (see **3.2.3 Restrictions on Investors**) before testing investors' interest.

3.3.6 Rules Concerning Marketing of Retail Funds

In the PRC, the rules applicable to the marketing of public funds include:

- the Securities Investment Fund Law;
- the Measures for the Operation and Administration of Public Funds;
- the Measures for the Administration of Information Disclosure of Public Funds; and
- the Appropriateness Measures.

The main rules that apply to the marketing of public funds are as follows.

Fund Registration With the CSRC

As discussed in **3.1.2 Common Process for Setting Up Investment Funds**, only public funds that have been registered with the CSRC may be marketed to the general public.

Fundraising Information Disclosures

The above regulations provide detailed requirements on the information that must be disclosed for fundraising of public funds. For example, the marketing document of a public fund must include the following information:

- basic information on the fund manager and the fund custodian;
- a summary of the contents of the fund contract and the fund custody agreement;
- the price, cost and duration of the fund units;
- the proportions of the remuneration and other related expenses of the fund managers and fund custodians; and
- risk warnings.

Risk Assessment and Matching Investors With Suitable Funds

Under the Appropriateness Measures, fundraisers may not actively conduct marketing of a public fund to general investors whose tolerance is lower than the risk rating of the fund (see **3.2.3 Restrictions on Investors**).

3.3.7 Marketing of Retail Funds

Upon registration of the public fund (see **3.1.2 Common Process for Setting Up Investment Funds**), public fund managers may conduct marketing towards the general public.

3.3.8 Marketing Authorisation/Notification Process

As discussed in **3.1.2 Common Process for Setting Up Investment Funds**, only public funds that have been registered with the CSRC may be marketed to the general public.

3.3.9 Post-Marketing Ongoing Requirements

Public fund managers who have marketed and closed a public fund must perform the following duties:

- information disclosure (see **3.1.4 Disclosure Requirements**);
- conducting separate management and separate accounting for different fund assets;
- distributing earnings to fund unit-holders promptly;
- convening fund unit-holders' general meetings according to the fund contract; and
- conducting accounting for the fund and preparing the financial accounting reports, the half-yearly and annual fund reports for the fund, etc.

3.3.10 Investor Protection Rules

Statutory Reporting Requirements

Public funds are subject to stricter reporting requirements than private funds. Public fund managers must publicise quarterly reports, semi-annual reports and annual reports of public funds. In addition, fund managers must publicise the net asset value of the fund and the fund units at least once a week.

3.3.11 Approach of the Regulator

The CSRC accepts both telephone and email enquiries from the general public. Face-to-face meetings are generally not available.

3.4 Operational Requirements

Restrictions on the Types of Investments for Public Funds

Public funds may only invest in listed securities, and investment scope is also restricted based on the type of public fund (see **3.3.1 Regulatory Regime**).

Asset Protection

Each public fund must appoint a bank custodian to hold the fund assets. Commercial banks and other financial institutions, including securities companies that have been approved by the CSRC, may serve as the custodian of a public fund.

Other Specific Operational Requirements

Liquidity risk control

Fund managers of open-ended public funds are required to establish and improve an internal liquidity risk-control system, including:

- a sophisticated management mechanism;
- a standardised business operations process;
- an independent and strict supervision system; and
- flexible emergency response plans.

Specific restrictions include that total investment in liquidity-restricted assets must not exceed 15% of the net asset value of an open-ended public fund.

In addition, in 2020 the CSRC issued guidelines for the side pocket mechanism of public funds, for liquidity risk-management purposes; a special account must be established for assets with high uncertainty in valuation.

Borrowing restrictions

While borrowing for making an investment is permitted, public funds are subject to certain borrowing restrictions as discussed in **3.5 Fund Finance**.

Valuation and pricing of assets of public funds

The CSRC has published a guiding opinion on public valuation, under which the basic principle is that public fund managers must determine the fair value of net assets in a timely manner, accurately and in accordance with statutory accounting rules, using valuation techniques supported by sufficient available data and other information. Other pricing guidelines are also provided with respect to specific businesses.

3.5 Fund Finance

Public funds are permitted to make borrowings for making an investment. Under the Guiding Opinions, the total assets of an open-ended public fund must not exceed 140% of its net assets, which means the borrowing must not exceed 40% of the capital, and the total assets of a closed-ended public fund must not exceed 200% of its net assets.

In the PRC, public fund managers may conduct margin trading by borrowing funds from securities companies approved by the CSRC. The securities company will require the borrower to provide the security at a certain percentage of the margin (which may be in the form of securities), and assets bought on margin in the borrower's account will also be a collateral for the margin trade.

3.6 Tax Regime

The applicable taxes mainly include stamp duty, EIT and IIT.

Tax for Funds

A stamp duty of 0.1% of the share price shall apply to the selling of shares by public funds. Gains of trading price difference of shares and bonds, as well as dividends from shares and interest from bonds, are exempted from the EIT.

Tax for Investors

Individual investors of public funds are exempted from the IIT on gain of redemption price over the subscription price, and dividends paid by the fund. However, institutional investors are not exempted from the 25% EIT on the gain of redemption price over the subscription price.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

New Rule Issued by the AMAC Regarding Private Securities Investment Funds

On 30 April 2024, the AMAC promulgated the Guideline for Operation of Private Securities Investment Funds (effective on 1 August 2024 (the "Guideline")). The Guideline raises the operational requirements for private securities investment funds, such as:

- clarifying that the minimum size for the existence of private securities investment funds is CNY5 million;
- clarifying the specific requirements for the frequency of redemption and the lock-up period;
- imposing stricter requirements regarding the information disclosure and the performance presentation; and
- a single private securities investment fund's investment in the same asset shall not exceed 25% of the fund's net assets, and the total investment in the same asset by all private securities investment funds managed by the same private fund manager shall not exceed 25% of the asset's total value.

The Guideline aims to further regulate private securities investment funds and better protect investors.

Trends and Developments

Contributed by:
Ping Zhang, Xining Dai and Moxi Zhang
Zhong Lun Law Firm

Zhong Lun Law Firm was founded in 1993, and is one of the largest full-service law firms in China. With effect from 17 April 2012, Zhong Lun has been restructured into an LLP under PRC law. It has over 2,400 professionals, including around 420 partners, working in 18 offices. Most of its lawyers have graduated from prestigious law schools in China and abroad, and many of them have practised in leading international law firms. All of the firm's partners are successful practitioners in their fields, and have extensive practice experience and in-depth knowledge of clients' businesses. Zhong Lun has served a diverse range of clients, including Fortune 500 multinationals, state-owned companies, growth enterprises, governmental bodies, international organisations, foreign embassies and consulates in China, foreign chambers of commerce in China, investment banks, private equity funds, insurance companies, trusts, real estate developers, service providers in sectors such as telecommunications, IT, tourism and traditional manufacturers.

Authors

Ping Zhang is one of the first PRC lawyers to practise in the investment funds field, and has accumulated more than ten years of sector experience. Mr Zhang has continually been recognised as a leading lawyer in investment funds by internationally renowned legal ranking organisations, including Chambers and Partners. He is also currently invited to serve as an expert member of several government-guided fund investment committees.

Xining Dai excels in the field of investment funds and asset management, and has represented well-known clients in their onshore and offshore venture and private equity investments. Ms Dai was rated as an Up and Coming Lawyer in the field of investment funds by Chambers and Partners in 2023 and 2024.

Moxi Zhang focuses her business scope mainly on private equity and investment funds, and has nearly eight years' experience in this area. She has represented private fund managers from different investment areas and with various backgrounds in setting up private equity and venture capital funds. In addition to fund formation, she is also experienced in investment and finance as well as in corporate governance.

Zhong Lun Law Firm

22-31/F
South Tower of CP Center
20 Jin He East Avenue
Chaoyang District
Beijing 100020

Tel: +86 105 957 2288
Fax: +86 106 568 1022/1838
Email: pingzhang@zhonglun.com
Web: www.zhonglun.com

CHINA TRENDS AND DEVELOPMENTS

Contributed by: Ping Zhang, Xining Dai and Moxi Zhang, **Zhong Lun Law Firm**

Overview of Investment Fund Markets

Influenced by changes in internal and external environments, increasingly stringent industry regulations, and market fluctuations, China's investment funds industry faces significant challenges in various aspects – including fundraising, establishment, investment and exit – which have not been seen in recent years. Compared to countries with mature investment funds markets, China's investment funds industry has entered the adjustment phase sooner. This adjustment phase is characterised by the following features.

Funding sources

State-owned capital has become the predominant funding source for investment funds. Investment from insurance funds, pensions and other institutional investors has also significantly increased, with the proportion of long-term capital rising further. Local governments actively promote the introduction of foreign capital, leading to a proliferation of qualified foreign limited partnership (QFLP) pilot programmes.

Exit channels

Exit opportunities are gradually leaning towards venture capital funds. Exit methods are primarily concentrated in "agreement transfers" and "corporate buybacks", while IPO transactions are experiencing a short-term decline.

Number of privately offered fund managers

The number of new registrations has sharply decreased, with a peak in deregistrations in 2023. Consequently, the number of existing privately offered fund managers has steadily declined, leading to higher industry concentration.

Number and scale of investment funds

Since 2022, the number of equity funds has been decreasing annually; in contrast, venture capital funds have experienced growth against the trend.

Equity investments

The trend of early-stage investments continues, with more than half of transactions occurring in the angel round to Series C.

As regards governmental supervision, with the release in the second half of 2023 of China's first administrative regulation specific to the private funds industry, the *Regulation on the Supervision and Administration of Privately Offered Investment Funds*, China's investment funds industry has entered a stage of standardised development with stringent regulation.

Historical and Forward-Looking Trends

The practice of investment funds in China began in the 1980s and has evolved over more than 40 years, generally encompassing three phases:

- emergence and inception;
- rapid development; and
- enhanced regulation.

Emergence and inception

In the 1980s, the Chinese government introduced the concept of "venture capital" for the first time, in an official document. During the following year, China's first domestic venture capital company – the China New Technology Venture Investment Company – was established. At this stage, regulations governing investment funds were not yet clear, and the establishment of investment funds was primarily government-led.

Rapid development

In the early 2000s, the private fund industry experienced significant growth, driven by the influx of foreign privately offered fund managers into the Chinese market and the rapid increase in private wealth. During this period, several key laws and regulations were successively issued, including but not limited to:

- the *Regulations on Administration of Foreign-Invested Venture Capital Enterprises* (issued in 2003, revised in 2015);
- the *Partnership Enterprise Law of the People's Republic of China* (originally issued in 1997, revised in 2006);
- the *Securities Investment Fund Law of the People's Republic of China* (originally promulgated in 2003, and revised in 2012 and 2015); and
- the *Notice on Promoting the Standardised Development of Equity Investment Enterprises* (issued on 23 November 2011).

This phase marked the emergence of the limited partnership structure in China, meeting the legal practical needs of forming investment funds. During this time, foreign funds also played a prominent role in the Chinese market.

Enhanced regulation

In 2013, the Chinese government designated the China Securities Regulatory Commission (CSRC) as the principal regulatory authority for the investment funds industry. The CSRC further delegated responsibilities to the Asset Management Association of China (AMAC), which is specifically responsible for the registration of fund managers and the filing of investment funds, and which carries out self-regulatory duties for the investment funds industry.

This ushered in a new era of regulatory oversight for investment funds. The AMAC has successively implemented numerous self-regulatory rules covering all aspects throughout the life cycle of investment funds, including (but not limited to):

- manager registration;
- fund filing;
- capital raising;
- information reporting and disclosure;
- fund agreements;
- abnormal fund operations;
- changes to funds or managers; and
- winding-up of funds and deregistration of managers.

These rules establish a comprehensive regulatory system for the fundraising, investment, management and exit stages of investment funds, with continuous strengthening of risk prompts and information disclosure to investors.

In 2023, the promulgation of the *Regulation on the Supervision and Administration of Privately Offered Investment Funds* marked the issuance of the first administrative regulation for the private funds industry. This regulation established the highest regulatory framework for investment funds.

The advent of the stringent regulatory measures mentioned above, the simultaneous entry of China's first batch of investment funds into their exit and liquidation phases, and the recent economic stagnation in China have collectively led to a surge in disputes and potential legal issues between investment funds and investors, as well as between investment funds and portfolio companies. The number of related cases has risen annually over the past several years.

This trend has drawn the attention of regulatory authorities, including the CSRC and the AMAC. There has been a notable increase in disciplinary actions and public notices being issued against investment fund managers in the past year. Consequently, demand for the compliance of domestic investment funds has grown dramatically.

However, challenges come hand in hand with opportunities. Currently, investment valuations in China have been rapidly adjusted to more reasonable levels, significantly enhancing the investment value of funds. Additionally, policies for attracting foreign capital into China have become significantly more relaxed compared to previous years.

Impact of Key New Regulations in 2024

The nationwide surge of QFLP funds

QFLP funds were a prominent topic among the vast majority of leading fund managers in 2024. On the one hand, a shortage of domestic renminbi capital has created a demand among dual-currency fund managers to accept US dollar capital into renminbi funds. On the other hand, local governments across China are actively promoting and encouraging foreign investments in renminbi funds.

The QFLP programme, introduced by the government as a pilot policy to facilitate foreign capital investment in renminbi funds through simplified currency conversion, is currently only limited to regions such as the Hainan Free Trade Zone, Beijing, Shanghai and Jiangsu Province. However, owing to the strong demand for foreign capital in various regions, the authors have observed that certain areas have significantly lowered the thresholds for QFLP qualification, making it an excellent opportunity for foreign investors to secure substantial currency conversion quotas.

The QFLP policy allows foreign investors to apply for large-scale conversion quotas for investment in renminbi funds, with the flexibility to contribute capital in instalments over an extended period (as stipulated in the fund agreement) rather than making a lump-sum payment. Capital brought in through QFLP must ultimately be invested in equity projects, including private equity (PE), venture capital (VC) or funds of funds (FOFs) targeting the above categories. Notably, the FOF investment model is permitted only in a smaller number of regions.

Impact of the 2024 Company Law on Equity Funds

In 2023, the Standing Committee of the National People's Congress passed the revised Company Law, representing the most substantial amendment since the 2005 revision. The revision, which came into effect in July 2024, encompasses corporate capital systems, governance structures, shareholder rights protection, and the rights and responsibilities of executives. This revision is expected to have a profound impact on corporate operations and governance in China.

The new Company Law directly or indirectly affects many traditional practices by PE funds as financial investors. Key changes include the following.

Registered capital and shareholder rights

This entails introduction of a mechanism requiring newly contributed registered capital of limited liability companies to be fully paid within five years, along with a corresponding shareholder forfeiture mechanism. This reform is expected to eliminate the proliferation of "shell companies" in China that have been artificially packaged for financial purposes.

Enhanced board responsibilities

The responsibilities of company directors are significantly heightened. New obligations include:

- a duty for the board to demand unpaid capital contributions from shareholders;
- joint and several liability of directors for shareholder withdrawals of capital;
- liability for directors involved in illegal capital reductions; and
- compensation liability for third parties where directors act with intent or gross negligence in performing their duties.

These provisions increase the legal exposure of fund-appointed directors on portfolio company boards, prompting investment funds to negotiate board seats more cautiously. Protective measures such as director indemnity letters and directors' and officers' (D&O) liability insurance are likely to become more prevalent.

Accelerated maturity of capital contributions

Under the new Company Law, if a company cannot repay due debts, creditors are entitled to demand the accelerated maturity of unpaid capital contributions. This enhancement of creditor protections imposes stricter operational and technical requirements on PE funds involved in the acquisition and restructuring of distressed enterprises.

The new Company Law reflects a clear shift towards stricter oversight, enhanced creditor rights and more robust governance. For PE funds, this necessitates more sophisticated legal, operational and risk-management strategies to navigate the evolving regulatory landscape.

Impact of the 2024 Guidelines on the Operation of Private Securities Investment Funds

On 30 April 2024, the AMAC issued the *Guidelines for the Operation of Private Securities Investment Funds* (the "Operation Guidelines"). These guidelines aim to establish a unique operational framework for private securities investment funds within the regulatory structure introduced by the *Regulation on the Supervision and Administration of Private Investment Funds* (2023).

Distinct from public securities funds and PE funds, the guidelines are tailored to the characteristics of private securities investment funds. The following highlight the key impacts of the Operation Guidelines.

Redemption restrictions

Unlike public securities funds, private securities investment funds cannot offer daily redemption. Instead, they must impose a minimum three-month lock-up period for fund shares or include a short-term redemption fee arrangement tied to the holding period, as stipulated in the fund agreement.

Diversification requirements

Private securities funds are generally required to adopt diversified investment strategies. For instance, a single fund's investment in any single asset must not exceed 25% of its net assets. However, funds meeting specific conditions may be exempt from these limits.

Leverage and derivative transactions

The total assets of a private securities fund cannot exceed 200% of its net assets.

Funds are prohibited from using over-the-counter (OTC) derivatives or other instruments to circumvent leverage restrictions or engage in OTC margin financing.

The Operation Guidelines introduce detailed and practical requirements for private securities funds engaging in OTC derivative transactions.

Open-end fund flexibility

Open-end private securities funds are encouraged to not set pre-warning or stop-loss thresholds, in principle.

These provisions collectively reflect the regulatory focus on maintaining stability, promoting prudent management and ensuring compliance within the private securities investment funds sector.

The Rise of the Stock Distribution Pilot Policy

In 2024, the CSRC, in collaboration with the AMAC, expanded the stock distribution pilot policy (which had previously been limited to a few cases) to cover a broader range of funds and investors.

The stock distribution pilot policy allows funds to directly transfer their held listed securities into the stock accounts of their investors, providing an innovative exit mechanism. This approach helps funds and investors mitigate the adverse effects of recent short-term fluctuations in China's stock market, and facilitates the smooth liquidation of funds nearing the end of their term.

For PE and VC funds, in-kind stock distribution to investors must comply with sell-off regulations, and can utilise block trading quotas for such distributions. These funds must also adhere to the "reverse linkage" policy – which means that, the longer an investment fund holds its equity stake in an unlisted company, the shorter the lock-up period for the public company shares obtained by it through mergers and acquisitions and share swaps.

Shares distributed in kind to investors become freely tradable stocks, and subsequent disposal of these shares is no longer subject to sell-off restrictions.

This policy represents a significant step in enhancing flexibility and innovation in fund exit strategies, while maintaining regulatory compliance and market stability.

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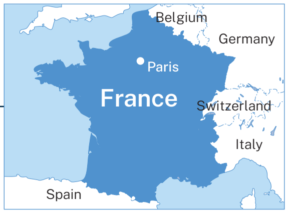

Law and Practice

Contributed by:
Rima Maitrehenry, Fabrice Rymarz, Charles-Xavier Vincenti and Stein Mpassi Loufouma
Racine

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Authors

Rima Maitrehenry focuses on the structuring of private funds. Her practice covers: fund formation for sponsors, management companies, first-time funds/first-time teams; negotiations for institutional investors, corporates and family offices regarding the terms and conditions of their investment in funds; buy-side, sell-side secondary transactions and continuation funds; regulatory aspects governing private funds (AMF approvals, AIFMD, MIFID, SFDR); and governance issues (conflicts of interests, team organisation, shareholding and carried interest). Rima is frequently involved in solving highly technical issues, finding innovative schemes that accommodate various constraints, and in cross-border transactions requiring negotiation and implementation of market standard terms.

Fabrice Rymarz is a partner who heads the tax practice and focuses on tax aspects of fund structuring, real estate and M&A transactions. His practice covers tax aspects relating to: fund formation; real estate transactions (asset deal/ share deal, and buy side/sell side); M&A transactions (buy side/sell side); tax structuring; and non-profit organisations.

Charles-Xavier Vincenti specialises in corporate taxation. His areas of intervention cover tax issues encountered by French companies in the framework of their activities (day-to-day management, exceptional operations). He notably assists investment funds in tax aspects related to the acquisition and structuring of their real estate operations. His expertise also covers collective investment schemes (UCITs and AIFs). He holds a master's degree in Tax Law from the University of Paris II Panthéon-Assas.

Stein Mpassi Loufouma advises French and foreign fund managers on all their legal and regulatory issues, in particular the structuring, offering and distribution of investment funds under French law (private equity, real estate, infrastructure, impact). Stein also assists fund managers in their dealings with the Autorité des marchés financiers (AMF) in all matters relating to the authorisation of management companies, the creation of investment funds and the marketing of investment funds in France and abroad. Stein assists fund managers and investors, both institutional and corporate, in primary and secondary transactions.

Racine

Racine
40 rue de Courcelles
75008 Paris
France

Tel: +33 144 824 300
Fax: +33 144 824 343
Email: contact.paris@racine.eu
Web: www.racine.eu

Contributed by: Rima Maitrehenry, Fabrice Rymarz, Charles-Xavier Vincenti and Stein Mpassi Loufouma, **Racine**

1. Market Overview

1.1 State of the Market

France is one of Europe's largest and most developed investment funds markets, with a strong presence in both retail and alternative investment funds (AIFs).

Governed by French regulator the *Autorité des marchés financiers* (AMF), the market benefits from stringent regulations aligned with EU Directives, such as UCITS (the Undertakings for the Collective Investment in Transferable Securities Directive) and the AIFMD (the Alternative Investment Fund Managers Directive).

The market is dominated by institutional fund managers and global asset management firms, supported by a robust network of banks and independent advisers.

Retail funds include equity, fixed income and balanced funds, while AIFs cover hedge funds, private equity, real estate and infrastructure funds.

Despite global economic uncertainties, the French funds market has remained active, driven by the growing demand for sustainable and ESG-aligned investment products.

For retail funds, there is a continued interest in UCITS-compliant funds, with inflows supported by household savings and tax-advantaged structures such as life insurance (*assurance vie*).

AIFs have seen increased activity in private equity and real estate, benefiting from France's attractiveness as a hub for innovation and green investments, especially with policies such as the *Loi Industrie Verte* encouraging ESG-focused strategies.

In fact, according to France Invest (the major French professional association promoting the private equity industry), 2023 was a more dynamic year for private equity in France than the global trend would suggest (the third best year in terms of fundraising since 2009, with EUR23.8 billion raised). This stable level of activity continued into H1 2024 (EUR9.5 billion raised) at a level comparable to H1 2023 (EUR8.6 billion raised) (see France Invest & Grant Thornton, *Activité du capital-investissement français au 1er semestre 2024* and *Activité du capital-investissement français en 2023*).

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Under French law, AIFs are classified into two main categories:

- AIFs by nature, or per se AIFs (*FIA par nature*); and
- AIFs by object, or Other AIFs (*Autres FIA*).

AIFs are generally divided into:

- AIFs dedicated to retail investors; and
- AIFs dedicated to professional investors, with this latter form being more flexible in terms of setting up and terms and conditions to be complied with.

Per se AIFs are specifically defined in the French monetary and financial code (FMFC), including rules governing their setting-up, terms and conditions. These rules are more specific than the ones set forth in Directive 2011/61/EU (the AIFMD). The Other AIFs include all other legal forms that operate as an AIF according to the AIFMD's definition. The Other AIFs are not subject to the same restrictions as the per se AIFs; however, they must comply with all regulations applicable to marketing (especially when proposed to retail investors), pre-contractual sustainability disclosures and, more generally, all rules set forth in the AIFMD.

Per se AIFs can be structured in:

- an unincorporated (or contractual) form (such as a *fonds commun de placement*), without legal personality; or
- a corporate form (with fixed or variable capital), with a legal personality.

Other AIFs may have any legal form recognised under French law.

Per se AIFs (whether in an unincorporated or in a corporate form) issue shares and units. Other AIFs may issue all interests that could be issued depending on their legal form.

Traditionally, the following investment strategies correspond to per se AIFs.

Generic alternative strategies are deployed through *fonds d'investissement à vocation générale* (FIVG), which could be set up in a form dedicated to professional investors or retail investors.

Real estate strategies are generally deployed through the *organisme de placement collectif immobilier* (OPCI) and *société civile de placement immobilier* (SCPI), both of which could be set up in a form dedicated to professional investors or retail investors.

Private debt strategies are generally deployed through the *organismes de titrisation* (OT, dedicated to retail investors) or the *organismes de financement spécialisés* (OFS, dedicated to professional investors).

Private equity strategies dedicated to retail investors are generally deployed through the *fonds de capital investissement*, comprising:

- *fonds commun de placement à risque* (FCPR);
- *fonds commun de placement dans l'innovation* (FCPI); and
- *fonds d'investissement de proximité* (FIP).

Alternatively, when dedicated to professional investors, they are deployed through the following legal forms:

- *fonds professional de capital investissement* (FPCI);
- *fonds professionnel spécialisé* (FPS); and
- *société de libre partenariat* (SLP) and *société de libre partenariat spéciale* (SLPS), which are specific legal forms of FPS.

Other AIFs could be used to deploy any investment strategy.

Per se AIFs must be managed by regulated portfolio management companies authorised to operate in France (even if their assets are below the AIFMD thresholds of EUR500 million for unleveraged funds and EUR100 million for leveraged funds). Other AIFs could be operated by unregulated managers under limited circumstances if they are below the above-mentioned thresholds and if they are exclusively proposed to professional clients as defined under MiFID Annex II.

Lastly, under Regulation (EU) 2015/760 (ELTIF) as amended by Regulation (EU) 2023/606, only certain legal form of French AIFs could benefit from the ELTIF label. These legal forms include the FPS, SLP and OFS.

Choosing the appropriate French AIFs from among the different available legal forms depends on a variety of factors, including:

- investment strategy;
- investment restrictions;
- flexibility of certain vehicles;
- taxation;
- benefit of a marketing or management passport; and
- types of investors.

2.1.2 Common Process for Setting Up Investment Funds

The setting-up of most French AIFs requires prior authorisation from the AMF, both for their creation and marketing. Subsequent changes to these funds may require either prior approval or immediate notification to the AMF, depending on the types of these changes. Interaction with the AMF is done through the ROSA platform, managed by the AMF and to which each fund manager authorised to operate in France has access.

The approval process for French AIFs depends on the type of fund; however, despite product-specific nuances the overall procedure remains largely uniform across products. AIFs open to retail investors are subject to more scrutiny from the AMF than those AIFs dedicated to professional investors.

While analysing the application of each AIF dedicated to professional investors, the AMF tends to be consistent with its internal doctrine. However, private equity funds dedicated to professional investors (FPCI, FPS, SLP, OFS and Other AIFs) could be set up without the prior authorisation of the AMF (other than for marketing purposes). They must only be notified ahead of their proposed marketing and then declared to the AMF within one month of their closing. This allows greater flexibility in defining contractual terms with investors and pursuing a fundraising process.

The other types of funds dedicated to professional investors and those dedicated to retail investors require, for their setting-up, the prior approval of the AMF (in addition to the marketing authorisation).

At a minimum, the application form to the AMF for private equity funds dedicated to professional and retail investors (FPCI, FPS, SLP, OFS, FCPR, OPCI, OPPCI and Other AIFs) includes the following documents:

- the AIF's legal documentation (prospectus, by-laws, articles of incorporation, etc);
- the Key Information Document (KID) prepared under the PRIIPS Regulation (EU 1286/2014) for funds marketed to retail investors;
- the disclosure forms required by the AIFMD;
- if the AIF manager (AIFM) does not intend to market the AIF to retail clients, the measures taken to prevent the units or shares of the AIF from being marketed to retail clients; and
- acceptance letters from service providers (eg, depositary, statutory auditor) that are either transmitted to the AMF with the other documents listed above (applicable for FPCI, FPS, SLP, OFS and Other AIFs) or made available to the AMF but not transmitted (applicable for FCPR, OPCI and OPPCI).

Funds that are subject to the AMF's prior approval must, in addition to the foregoing list, provide the AMF with other documents, whose type and content depends on their respective legal form. More generally, the AMF could ask for any information and document that is necessary for the approval process.

French-based AIFMs are subject to annual AMF fees based on assets under management (in France and outside France), and this amount cannot be less than EUR1,500. Non-French-based AIFMs are subject to a EUR2,000 registration fixed annual fee per fund that is marketed by them in France.

2.1.3 Limited Liability

Per se AIFs provide that investors' liability is limited to the amount of their commitment in the fund. The limited liability of Other AIFs depends on their legal form. When setting up Other AIFs, fund managers tend to choose the legal form that limits the liability of the investors to the amounts invested by them in the fund.

2.1.4 Disclosure Requirements

Disclosure requirements relating to French AIFs are those applicable pursuant to the AIFMD and Regulation (EU) 2019/2088, as amended, relating to sustainable finance disclosure (SFDR).

These disclosures consist mainly of:

- pre-contractual information to be made available to investors before they invest in the fund (Article 23 of the AIFMD);
- pre-contractual information on sustainability, depending on the AIF's classification under the SFDR; and
- an annual report, to be prepared within six months of financial year-end.

On top of the AIFMD reporting requirements, French law provides for an additional disclosure measure for certain per se AIFs. FCPR, FPCI, SLP, FPS and OFS are required to establish a semi-annual report within two months following the end of a semester.

This semi-annual report includes:

- an inventory of the portfolio of assets held by the AIF; and
- the AIF's net assets, number of shares/units issued, liquidation value and off-balance sheet commitments.

A document called "asset composition", which is part of this semi-annual report, is verified by the AIF's statutory auditors.

AIFs' marketing materials should be in line with the AIFMD and with the European Securities and Markets Authority (ESMA) guidelines (ESMA34-45-1244). On top of this, such marketing materials must also comply with French regulations (including the AMF doctrine).

Fund managers regulated by the AMF are required to report to the AMF, on a regular basis. This includes AIFMD reporting and the reporting of certain events (breach of ratio, payment of indemnification to investors, etc) or of financial data (liquidation value, assets under management, etc).

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Investors in AIFs are either retail investors or professional investors. Retail investors (such as individuals, family offices and/or high net worth individuals) usually invest in AIFs through a distributor's network (private banks, insurance companies and investment advisers). Professional investors consist of banks, insurance companies and large corporations investing on their own account, as well as fund managers managing investment funds or investment service providers managing third-party mandates. Professional investors also include sovereign funds (or equivalent) as well as development finance institutions.

Certain per se AIFs are more attractive to French private and/or corporate investors because of certain tax incentives attached to them.

For 2023, according to France Invest, the breakdown of fundraising by type of investor was as follows:

- funds of funds/other asset managers, 27%;
- individuals/family offices, 23%;
- insurance companies/mutual insurers, 13%;
- banks, 8%;
- pension funds, 8%;
- public sector, 8%;
- industrials, 6%; and
- sovereign funds, 6%.

In H1 2024, funds of funds/other asset managers and insurance companies/mutual insurers increased their commitments (+61% and +31% respectively compared to H1 2023). Individuals and family offices reduced their allocations, but remain the second largest category of subscribers (20% of commitments) (see France Invest & Grant Thornton, *Activité du capital-investissement français au 1er semestre 2024* and *Activité du capital-investissement français en 2023*).

2.2.2 Legal Structures Used by Fund Managers

See **2.1.1 Fund Structures**.

2.2.3 Restrictions on Investors

No specific restrictions are provided for French AIFs open to retail investors. However, the AIFM managing such funds must have an AMF pre-approved programme of operations dedicated to retail investors.

Per se AIFs dedicated to professional investors may only be invested in by:

- the fund manager, its directors and employees;
- professional clients as defined under MiFID;
- retail clients whose commitments in such AIF are at least equal to EUR100,000; and
- retail clients investing through an investment services provider in the context of a discretionary portfolio management mandate.

Certain per se AIFs dedicated to professional investors may benefit from additional exemptions permitting them to attract non-professional investors:

- FPCI, OFS and FPS could, under certain conditions, be invested in by natural persons and legal entities, whose initial subscription is equal to EUR30,000;
- SLP could be invested in by individuals or legal entities rendering services to the AIFM; and
- FPCI, OFS, FPS and SLP benefiting from the ELTIF label could be invested in by retail investors.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

As already indicated (see **2.1.1 Types of Investors in Alternative Funds**), per se AIFs and Other AIFs must be managed by a portfolio management company regulated by the AMF, or must otherwise be authorised to operate in France as an AIFM.

Other AIFs are not subject to any particular investment limitations other than those contractually agreed upon between the fund manager and the AIF's investors.

Per se AIFs are subject to certain investment limitations depending on their respective investment strategy. For example, an FIVG used for generic alternative investment strategies cannot invest more than 10% of its assets in unlisted companies. Meanwhile, an FPCI or an FCPR dedicated to investments in unlisted securities is required to invest at least 50% of its assets in equity/equity-like securities issued by unlisted companies. Additional restrictions apply to FCPI and FIP (both vehicles are dedicated to retail investors), for which, in addition to this investment quota of 50%, a specific investment quota of 70% in certain types of unlisted investments is required.

Per se AIFs dedicated to retail investors are subject to diversification rules that are not applicable to per se AIFs dedicated to professional investors. For example, an FCPR cannot invest more than 10% of its assets in a single issuer, whereas such limitation is not available for FPCI.

Lastly, OFS, FPS and SLP are generally the only per se AIFs that do not have investment limitations, other than those contractually agreed upon between the fund manager and the AIF's investors.

2.3.2 Requirements for Non-Local Service Providers

In addition to a regulated portfolio management company and/or AIFM, French AIFs require a custodian and a statutory auditor. Unlike the AIFM – which could be based in another EU member state yet nonetheless be able to manage a French AIF on a cross-border basis through the management passport under the AIFMD – custodian and statutory auditors must be based in France.

The custodian is subject to regulation/registration requirements. It is usually a banking/credit institution.

Statutory auditors must be registered with the *Compagnie nationale des commissaires aux comptes* (CNCC), the national regulatory body for statutory auditors in France.

The fund administration of French AIFs is generally handled by their respective portfolio management company and/or AIFM, but can also be delegated or outsourced to third parties. In this case, such delegation or outsourcing must comply with delegation/outsourcing requirements as set forth in the AIFMD and in French regulations. In particular, the AIFM should define in its programme of operations the essential tasks and functions for which it intends to outsource/delegate. It must also formalise the process of selecting and monitoring the service provider on the basis of appropriate criteria, and must retain the ability to evaluate the service provided in order to be able to control it.

2.3.3 Local Regulatory Requirements for Non-Local Managers

As already indicated (see **2.2.1 Types of Investors in Alternative Funds**), per se AIFs and Other AIFs must be managed by a portfolio management company regulated by the AMF, or must otherwise be authorised to operate in France as an AIFM.

A fund manager located in another EU member state could manage a French AIF on a cross-border basis through the management passport under the AIFMD. However, since this management passport is only available for AIFs invested in by professional investors, such fund manager is not allowed to manage a French AIF unless this AIF is strictly limited to professional investors. In other words, even if certain AIFs dedicated to professional investors are authorised to attract retail investors (see **2.2.3 Restrictions on Investors**), such flexibility is no longer available when these AIFs are managed on a cross-border basis by an EU fund manager under the AIFMD management passport.

2.3.4 Regulatory Approval Process

For AIFs that require the AMF's prior approval for their setting-up (see **2.1.2 Common Process for Setting Up Investment Funds**), the authorisation process does not exceed one month. This timeframe begins from the date the AMF acknowledges receipt of a complete application.

The completeness of the initial application is crucial for the process to proceed smoothly. If the application is incomplete, the timeline may be extended while the applicant addresses any deficiencies.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

These rules are identical to the ones provided by Directive 2019/1160/EU, amending the AIFMD. Any French or EU AIFM undertaking the pre-marketing of a French or EU AIF's interests to professional clients in France must send a pre-marketing notification to the AMF within two weeks of starting this pre-marketing.

2.3.6 Rules Concerning Marketing of Alternative Funds

These rules are identical to the ones provided by the AIFMD.

In particular, marketing of AIFs in France is subject to either an AMF notification (for marketing towards professional investors) or an AMF prior authorisation process (for marketing towards retail investors).

In practice:

- French and EU AIFs managed by French AIFMs are authorised to be marketed in France to professional clients, subject to a prior notification to the AMF;
- French and EU AIFs managed by EU AIFMs are authorised to be marketed in France to professional clients via the marketing passport (prior notification to the AMF through the AIFM supervisory authorities);
- third-country AIFs managed by third-country AIFMs are authorised to be marketed in France to professional clients or retail clients, subject to a prior authorisation by the AMF and to compliance with equivalence requirements; and
- French or EU AIFs managed by French or EU AIFMs are authorised to be marketed in France to retail investors, subject to a prior authorisation by the AMF and equivalence requirements.

The following conduct is not considered "marketing":

- reverse solicitation; and
- contacts made with funds-of-funds managers or investment service providers, provided that the funds and/or the mandates managed by them are eligible to invest in the AIF proposed to them.

2.3.7 Marketing of Alternative Funds

French AIFs could be marketed to investors (either French or non-French) eligible to invest in such AIFs (retail, professional, etc; see **2.2.3 Restrictions on Investors**).

Non-French AIFs could be marketed to French investors (see **2.3.6 Rules Concerning Marketing of Alternative Funds**) through either:

- the marketing passport available under the AIFMD, in which case the marketing is limited to professional investors; or
- a specific prior authorisation from the AMF for all other cases (such prior authorisation is often difficult to obtain since it is based on equivalence treatments/rules, as applicable to AIFMs).

2.3.8 Marketing Authorisation/Notification Process

The marketing authorisation/notification is identical to that provided by the AIFMD. In practice, the following applies.

For French or EU AIFs managed by French AIFMs and dedicated to professional clients, the marketing authorisation must be requested from the AMF via the ROSA extranet platform.

For French or EU AIFs managed by EU AIFMs and dedicated to professional clients, their marketing in France is subject to prior notification to the AMF via the AIFM supervisory authorities. Marketing may begin in France as of the date of notification to the AMF by such authorities.

French AIFs managed by French AIFMs are authorised to be marketed in France to retail investors, subject to a prior authorisation by the AMF submitted via the ROSA extranet platform.

EU AIFs managed by EU AIFMs may be marketed to French retail investors, subject to a prior authorisation by the AMF and to compliance with the following conditions:

- that an instrument of exchange of information and mutual assistance in the field of asset management on behalf of third parties is in place between the AMF and the supervisory authority of the AIF's AIFM; and
- that the AIF complies with the conditions set out in a mutual recognition agreement on AIFs authorised to be marketed to retail investors, concluded between the AMF and the AIF's AIFM supervisory authority.

Third-country AIFs may be marketed in France to professional clients and/or retail investors subject to the prior authorisation of the AMF and to compliance with the following conditions:

- for marketing to professional clients – compliance with the AIFMD, and existence of a co-operation agreement between the AMF and the third-country supervisory authority of the AIF's AIFM;
- for marketing to retail investors – an instrument of exchange of information and mutual assistance in the field of asset management on behalf of third parties being in place between the AMF and the supervisory authority of the AIFM's AIF; and
- the AIF's compliance with the conditions set out in a mutual recognition agreement on AIFs authorised to be marketed to retail investors, concluded between the AMF and the supervisory authority of the AIF's AIFM.

2.3.9 Post-Marketing Ongoing Requirements

When an AIF has been marketed in France, the AMF considers this AIF as still marketed in France as long as investors to whom such AIF has been marketed remain investors in the AIF. The marketing authorisation or marketing notification must be maintained as long as French investors continue to hold units or shares in this AIF.

Any material changes in the information contained in the initial marketing notification must be notified to either the AMF or, for AIFs marketed in France on a cross-border basis, the home state competent authority.

If an AIF is no longer marketed in France, a notification to deregister it should be made with either the AMF or, for AIFs marketed in France on a cross-border basis, the home state competent authority. From the date of deregistration, a 36-month "black-out" period is triggered, during which any pre-marketing of the relevant AIF or in respect of similar investment strategies or ideas is prohibited.

2.3.10 Investor Protection Rules

See **2.3.9 Post-Marketing Ongoing Requirements.**

2.3.11 Approach of the Regulator

The AMF personnel in charge of reviewing filings can be contacted by email or by phone. Face-to-face meetings can be requested from the AMF, but usually these meetings are reserved for exceptional, non-standard issues or transactions. However, the marketing process is performed online through:

- a dedicated email address (passports-AIFM@amf-france.org) for pre-marketing; and
- the ROSA extranet (or via a regulator-to-regulator notification mechanism) for marketing.

2.4 Operational Requirements

Operational requirements of French AIFs, including the requirement for a custodian, are described in **2.1.1 Fund Structures**, **2.3.1 Regulatory Regime** and **2.3.2 Requirements for Non-Local Service Providers.** Borrowing restrictions are described in **2.5 Fund Finance.**

Details on how an AIF's assets are valued must be described in the AIF's legal documentation. Valuation rules depend on the nature of the underlying assets. International standards such as the IPEV valuation guidelines are commonly used in French private equity finds. The fund manager retains responsibility for valuing the AIF's assets.

AIFs investing in listed assets must comply with rules governing insider trading, market abuse and short-selling.

Lastly, French fund managers are required to perform know-your-client/anti-money laundering checks.

2.5 Fund Finance

Other AIFs are not subject to any borrowing restrictions.

Per se AIFs could be subject to borrowing restrictions depending on their legal form. For example, FCPR and FPCI cannot incur direct cash borrowing in excess of 30% of their net assets, whereas such cash borrowing is not restricted for FPS, SLP and OFS (unless these vehicles are structured to originate loans, in which case their maximum leverage is capped at 30% of their net assets).

In general, borrowing restrictions (if any) are dealt with contractually among fund managers and AIFs investors. The various borrowing schemes and structuring depend on whether the AIF is to be considered a leveraged fund or an unleveraged fund. For leveraged funds, borrowing is incurred at the level of special purpose vehicles (SPVs) controlled by the AIF, and lenders are granted pledges and securities on the assets of such SPVs and/or on the interests held by the AIF in such SPVs. Leveraged funds are often used in real estate transactions.

For unleveraged funds, borrowings are often used to bridge capital calls. Cash is borrowed by the AIF from a lender, mainly in anticipation of a capital call. This type of borrowing takes the form of a revolving credit facility to be reimbursed within a maximum period of 364 days through capital calls made by the AIF's investors. Lenders are generally granted pledges on the AIF's bank account and investors' undrawn commitments.

Other alternative fund financing structures have been developed in recent years, such as NAV financing secured with the AIF's underlying assets or the issuance of unsecured preferred equity. Entering into such type of financing requires amendments to the AIF's legal documentation in order to waive any indebtedness (if feasible for AIFs that are not subject to a legal indebtedness restriction). For AIFs that are dedicated to retail investors, such amendments require the prior approval of the AMF, which could prove difficult to obtain for such type of borrowing scheme.

2.6 Tax Regime

In most cases, French AIFs are not subject to taxation in France as they either benefit from a French corporate income tax (CIT) exemption or are not subject to CIT, depending on their legal and regulatory status. There are, however, a few exceptions.

Taxation (if any) generally occurs at the investors' level on income received from the AIFs (ordinary income and/or gain derived from investments) based on their own tax regime.

French AIFs Exempt From CIT ("French Exempt AIFs")

Scope of CIT exemption

These French Exempt AIFs are set up as corporate entities and are, in principle, liable to CIT but benefit from an exemption because of their regulatory status or their corporate purpose (notably FPS set up as SICAV and OPCI/OPPCI incorporated as SPPICAV).

The CIT exemption regime may be subject to conditions: in particular, SPPICAVs must comply with annual dividend distribution requirements.

As this category of French AIFs is considered opaque for tax purposes, the investors will be deemed to receive French-source dividends. CIT-exempt AIFs set up as SICAV do, however, have the possibility to "ventilate" (so-called *couponnage*) their profits and gain so that they keep their underlying nature (real dividends, interest, capital gains) and their source (French or foreign source) when distributed to investors.

Individual investors resident in France

Fund investors are taxed on proceeds generated by the French Exempt AIF on the date of their effective redistribution, not on the date the income is received by the French Exempt AIF.

Dividends distributed by the French Exempt AIF are subject to a 12.8% French flat tax (*prélèvement forfaitaire unique* – PFU) and to social security contributions at the current overall rate of 17.2%, resulting in a total taxation of 30% (up to 34% for investors with a significant annual taxable income).

A French Exempt AIF that ventilates its income can also distribute interest/capital gains to its investors. The taxation rate is the same, however.

If more favourable, investors may elect to tax their investment income (dividends, interest, capital gains) according to the progressive scale of individual income tax. This election is global and annual.

Foreign-source income distributed to investors (in situations where a SICAV is ventilating its income) may also be subject to tax in France. The investor should, however, be able to deduct all or part of the tax credits attached to the income/gains redistributed by the fund.

Capital gains resulting from the sale of redemption of the French Exempt AIFs' shares are also subject to the PFU, unless the investor has elected to apply the progressive scale of individual income tax.

Legal entities' investors resident in France

French companies' investors subject to CIT are required to retain a "mark to market" approach for shares held in French Exempt AIFs (the "Mark-to-Market Rule"). As a consequence, unrealised gains or losses must be taken into account on a fiscal year basis for CIT computation purposes. CIT applies at a 25% rate (increased to 25.825% when the social contribution of 3.3% applies).

The Mark-to-Market Rule does not apply to:

- French companies whose main activity is life insurance or capitalisation insurance, and to non-profit organisation; and
- stakes held in French Exempt AIFs investing more than 90% of their commitments in companies located in the EU and subject to corporate income tax.

Note: a specific exemption exists for certain tax-transparent funds meeting specific investment criteria. Please see **French AIFs Outside the Scope of CIT ("French Transparent AIFs")** below.

Dividends distributed to investors are subject to CIT under standard conditions in respect of the fiscal year in which such income is distributed. The French parent-subsidiary regime is not applicable to these distributions.

Corporate investors should be able to deduct tax credits attached to non-French source income generated by the French AIF (only if this AIF is entitled to ventilate its income).

Capital gain realised upon the sale of a French AIF's shares is also subject to CIT at the standard rate. Corporate investors cannot benefit from a favourable tax regime (such as the long-term capital gain regime implemented in France).

Non-resident investors

In principle, dividends distributed by French AIFs are subject in France to a withholding tax of 25%, upon their distribution to investors. Different applicable rates may, however, apply:

- 12.8% when the beneficiary is a non-resident individual;
- 15% when the beneficiary is a non-profit organisation (subject to certain conditions);
- 75% if the dividends are paid in a non-cooperative state or territory (the French tax authorities have published a list of these states/territories, which is updated from time to time); and
- 0% when the beneficiary is a foreign investment fund deemed to be "comparable" to a French fund, by having similar regulatory and legal characteristics.

When a fund is ventilating its distributions (SICAV), the applicable tax regime will depend on the nature and source of the underlying income, as follows.

Non-French-source income should not be subject to any taxation in France, as such income is not considered as having its source in France.

French-source dividends (dividends deriving from French subsidiaries of the fund) follow the same tax regime as the one explained above for dividends.

French-source interest should not be subject to any withholding tax in France unless such interest is wired in a bank account located in a non-cooperative state or territory.

French-source capital gains are, in principle, exempt from French taxation unless the investor holds, directly or indirectly, an equity stake exceeding 25% over the five-year period preceding the disposal of the French company by the French Exempt AIF. Otherwise, a taxation would apply (12.8% for a foreign individual, 25% for a foreign corporate investor). Specific rules may apply when the investor is a foreign investment fund (exemptions under certain conditions) or when the capital gain derives from the sale of a French real estate rich company.

Capital gain deriving from the sale of the French AIF's shares

In principle, capital gains are exempt. As an exception, any investor holding more than 25% of the French AIF's shares might be subject to taxation in France under the same rules as those explained above for French-source capital gains distributed by the fund.

French AIFs Outside the Scope of CIT ("French Transparent AIFs")

Scope of tax transparency

These AIFs are not subject to CIT (and are therefore considered "tax-transparent"):

- because of their legal status – most of these funds have no legal personality (FPS set up as FCP, FPCI, SLPS, etc); or
- because of a specific tax provision – SLP have a legal personality (contrary to SLPS) but French tax rules provide that their tax regime is identical to the one applicable to FPCI (which are tax-transparent funds).

French Tax Regime Applicable to Investors of French Transparent AIFs

Preliminary comments

Because of their tax transparency, income distributed by French Transparent AIFs keep their nature (dividends, interest, capital gain) and their source (French/non-French).

French tax residents of certain French Transparent AIFs (FCPR, FCPI, FIP, FPCI, SLP, SLPS) can benefit from a tax-favourable regime provided that these funds comply with a tax investment quota (the "Tax Quota"), when at least 50% of their assets correspond to shares issued by companies that:

- are located in the EU or the European Economic Area (EEA);
- carry out a commercial/industrial activity; and
- are liable for corporate income tax in their country of establishment.

Individual investors residents in France

When the French Transparent AIF does not meet the Tax Quota criteria, the following applies.

For distribution of dividends, interest and capital gains, French individual investors are subject to a 30% overall taxation (up to 34% for high-income investors) unless they elect to apply the progressive scale of individual income tax. Investors should benefit from any tax credits attached to non-French-source income.

By way of exception, capital gains are taxable upon their realisation by the fund (even if they are not distributed to individual investors) if at least one individual investor owns at least 10% of the fund's securities.

For allocation of assets (*répartitions d'actifs*), some French Transparent AIFs (eg, SLP, SLPS, FPCI, FCPR) are entitled to distribute a portion of their assets in cash (they correspond to the sale price of the shares held in the French Transparent AIF) or in securities.

Asset allocations to French individual investors are non-taxable up to the amount of the investors' contributions into the fund. The portion exceeding the contribution made by the investor to the fund (or the acquisition price of its shares) is treated as capital gain subject to the same tax regime as the one mentioned above for distribution of capital gains by the fund.

Capital gain generated upon the sale/redemption of the French Transparent AIF's securities follows the same tax regime as the one applicable to distribution of capital gains.

When the French Transparent AIF meets the Tax Quota criteria, the following applies.

French individual investors can benefit from a favourable tax regime if they comply with these conditions:

- subscribing the fund's shares (and not acquiring existing shares) and undertaking to hold such shares for at least five years from the subscription date;
- the amounts allocated by the fund to an individual investor during this five-year period must be immediately reinvested by this investor in the fund; and
- investors must not hold, directly or indirectly, alone or with their spouse, ascendents and descendants, an equity stake of more than 25% in companies invested by the fund (and at any time in the five years preceding the subscription date).

If so, French individual investors are exempt from French individual income tax on:

- income/capital gains distributed by the French Transparent AIF; and
- capital gains deriving from the sale/redemption of the AIF's securities.

However, 17.2% security contributions remain due.

Legal entities' investors resident in France

When the French Transparent AIF does not meet the Tax Quota criteria, the following applies.

French corporate investors must apply the Mark-to-Market Rule unless one of the exemptions applies.

CIT is applicable at standard rates to all distributions of the fund (dividends, interest, capital gains, allocations of assets; note that tax credit attached to these distributions can be deducted) and to capital gains generated upon the sale/redemption of the French Transparent AIF's securities.

When the French Transparent AIF meets the Tax Quota Criteria, the following applies, and French corporate investors may benefit from a tax-favourable regime.

An exemption from the Mark-to-Market Rule is available, provided that investors undertake to keep the French Transparent AIF's securities for at least five years from the subscription/acquisition date.

Asset allocations are deemed to be in priority and a non-taxable repayment of capital contributions. The amount exceeding such repayment is treated as long-term capital gain for tax purposes when the French Transparent AIF's securities held by the investor were issued by the fund for more than two years on the date of the distribution.

If so, the capital gain may benefit from a full CIT exemption when the asset allocation derives from the sale of companies in which the fund held at least 5% of the share capital for at least two years. However, this exemption is not applicable in certain cases (notably when the fund sold real estate-rich companies); instead, a 15% reduced rate may apply.

The capital gain generated upon the sale/redemption of the fund's securities can benefit from the long-term capital gain regime when the investor holds these securities for at least five years. If so, the capital gain is:

- exempt from CIT in proportion to the fund assets corresponding to securities of companies in which the fund has held at least 5% of the capital for at least two years; and
- subject to a 15% CIT for the remaining amount.

Note: dividends and interest distributed by the fund still remain subject to CIT at the investors' level.

Non-resident investors

Their tax regime is similar to the one applicable to non-resident investors of French Exempt AIFs that ventilate their income.

Regarding French-source income distributed by the funds, it is worth mentioning that tax treaties concluded between France and the investor's state of residence would likely limit the amount of withholding tax applied in France, since the investor is deemed to have directly received the income.

French AIFs Subject to CIT

Other French AIFs can be set up as French companies subject to CIT under standard rules (notably, a French *société par actions simplifiée* – SAS). These funds are therefore subject to tax at a 25% standard rate (increasing to 25.83% if the additional CIT contribution applies).

Investors of French Other AIFs set up as companies subject to CIT are taxable when the Other AIF distributes dividends. Please refer to above discussion of French Exempt AIFs, which are subject to certain differences – in particular, as follows.

- French corporate investors can benefit from the parent-subsidiary regime, provided that they hold at least 5% of the French Other AIF's shares for two years. Dividends are therefore exempt from CIT at their level, apart from a lump sum equal to 5% of the dividends.
- Foreign corporate investors may rely on the provision of the EU Parent-Subsidiary Directive to obtain a full withholding tax exemption.

French OFS set up as corporate entities are also subject to CIT. However, special adjustment rules apply for the computation of their taxable income.

Other AIFs Dedicated to Real Estate Investment

A few AIFs can be set up as partnerships (*sociétés de personnes*), such as real estate investment companies (SCPI or Other FIAs set up as SCI). SCPI and SCI are pass-through entities not subject to CIT per se. The taxable income is computed at their level but automatically taxed in the hands of their investors (even if the income is not effectively distributed) based on the rules applicable to real estate income. Accordingly, the following applies.

French individual investors are generally subject to the progressive scale of income tax (increase by a 4% contribution for high-income investors). Social security contributions are also applicable at a 17.2% rate.

French corporate investors are subject to CIT under standard conditions.

Foreign investors should also be subject to tax in France on real estate income deriving from real estate assets located in France (based on the same rules applicable to French investors, depending on whether they are individual or corporate investors), subject to the provisions of applicable double tax treaties.

A French real estate fund can be set up as a *fonds commun de placement immobilier* – FPI. FPI are outside the scope of CIT, provided that they comply with mandatory income distributions. Investors are taxable on the date of their effective redistribution based on the rules applicable to real estate income (which are described above).

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

See **2.1.1 Fund Structures**.

3.1.2 Common Process for Setting Up Investment Funds

See **2.1.2 Common Process for Setting Up Investment Funds.**

3.1.3 Limited Liability

See **2.1.3 Limited Liability**.

3.1.4 Disclosure Requirements

See **2.1.4 Disclosure Requirements**.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

See **2.2.1 Types of Investors in Alternative Funds**.

3.2.2 Legal Structures Used by Fund Managers

See **2.2.2 Legal Structures Used by Fund Managers**.

3.2.3 Restrictions on Investors

See **2.2.3 Restrictions on Investors**.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

See **2.3.1 Regulatory Regime**.

3.3.2 Requirements for Non-Local Service Providers

See **2.3.2 Requirements for Non-Local Service Providers.**

3.3.3 Local Regulatory Requirements for Non-Local Managers

See **2.3.3 Local Regulatory Requirements for Non-Local Managers.**

3.3.4 Regulatory Approval Process

See **2.3.4 Regulatory Approval Process.**

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

See **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds.**

3.3.6 Rules Concerning Marketing of Retail Funds

See **2.3.6 Rules Concerning Marketing of Alternative Funds.**

3.3.7 Marketing of Retail Funds

See **2.3.7 Marketing of Alternative Funds.**

3.3.8 Marketing Authorisation/Notification Process

See **2.3.8 Marketing Authorisation/Notification Process.**

3.3.9 Post-Marketing Ongoing Requirements

See **2.3.9 Post-Marketing Ongoing Requirements.**

3.3.10 Investor Protection Rules

See **2.3.10 Investor Protection Rules.**

3.3.11 Approach of the Regulator

See **2.3.11 Approach of the Regulator.**

3.4 Operational Requirements

See **2.4 Operational Requirements.**

3.5 Fund Finance

See **2.5 Fund Finance.**

3.6 Tax Regime

There are no differences between the tax treatment of retail investors and professional investors. When investing in French Exempt AIFs and French Transparent AIFs (notably those that can comply with the Tax Quota), retail investors are subject to the same tax regime as the one explained for professional investors in **2.6 Tax Regime.**

However, the following tax incentives may be especially relevant for French individual retail investors:

- securities of certain retail funds may be invested through a personal equity savings plan (*plan d'épargne en actions*) or a life insurance contract – the income received through these schemes can benefit from a favourable tax regime, under certain conditions; and
- the subscription to securities of certain retail funds (notably FIP and FCPI) may, under certain conditions, grant individual investors an income tax reduction.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

2024 saw a number of improvements in the French asset management industry, aimed at making certain French fund vehicles more attractive. The following is a brief overview of some of the main developments, by AIF type.

FCPR

Increase in the market capitalisation threshold for companies in the EEA, whose equity securities may be held by FCPR, from EUR150 million to EUR500 million, with such investments being included in the 50% of unlisted investment quotas (*Loi Attractivité* No 2024-537 du 13/6/2024). The calculation of the 50% FCPR investment quota has been amended to permit the taking-into-account of not only direct investments in eligible assets made by certain entities in which an FCPR invests but also indirect investments of such entities in such eligible assets (*Ordonnance du 3 juillet 2024 portant modernisation du régime des fonds d'investissement alternatifs*).

SLP

Creation of an unincorporated form of SLP having a limited liability company, the *société de libre partenariat spéciale* (SLPS). The SLPS does not have legal personality (*Ordonnance du 3 juillet 2024 portant modernisation du régime des fonds d'investissement alternatifs*).

FPS, SLP and OFS

Amendment to the legal regime for FPS, SLP and OFS to allow these funds to issue tracking shares and bonds. Tracking shares and bonds "track" and reflect the economic performance of a given asset or category of assets in the fund's portfolio (*Ordonnance du 3 juillet 2024 portant modernisation du régime des fonds d'investissement alternatifs*).

FPCI

Deletion of the 10% limit on the holding of receivables by an FPCI to facilitate its recognition as an ELTIF 2.0 (*Ordonnance du 3 juillet 2024 portant modernisation du régime des fonds d'investissement alternatifs*).

Trends and Developments

Contributed by:
Rima Maitrehenry
Racine

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Author

Rima Maitrehenry focuses on the structuring of private funds. Her practice covers: fund formation for sponsors, management companies, first-time funds/first-time teams; negotiations for institutional investors, corporates and family offices regarding the terms and conditions of their investment in funds; buy-side, sell-side secondary transactions and continuation funds; regulatory aspects governing private funds (AMF approvals, AIFMD, MIFID, SFDR); and governance issues (conflicts of interests, team organisation, shareholding and carried interest). Rima is frequently involved in solving highly technical issues, finding innovative schemes that accommodate various constraints, and in cross-border transactions requiring negotiation and implementation of market standard terms.

Racine

Racine
40 rue de Courcelles
75008 Paris
France

Tel: +33 144 824 300
Fax: +33 144 824 343
Email: contact.paris@racine.eu
Web: www.racine.eu

racine
AVOCATS

Contributed by: Rima Maitrehenry, **Racine**

Background

On 23 October 2023, France adopted the Green Industry Act (*Loi sur l'Industrie Verte* No 2023-973) (the "Act"). The Act has three main objectives:

- facilitating the establishment and development of industrial sites;
- encouraging virtuous companies in public procurement processes; and
- financing the green industry.

Firstly, the Act aims to simplify the establishment of economic activity as well as the setting-up of industrial projects such as wind power, photovoltaics, heat pumps, batteries and low-carbon hydrogen, by instituting simultaneous administrative appraisal of such projects along with public consultation. In particular, the Act introduces a simplified exceptional procedure controlled by the State for industrial projects of major national interest. It also seeks to accelerate the redevelopment of brownfield sites and to facilitate the implementation of compensation obligations for project developers who have an impact on biodiversity.

Secondly, the Act aims to "greenify" public procurement law, notably through an optional exclusion from procedures for the awarding of public contracts and concession contracts of companies that do not comply with their obligations under Directive (EU) No 2022/2464 of the European Parliament and of the Council of 14 December 2022 (the Corporate Sustainability Reporting Directive (CSRD)) and of companies that do not comply with their obligations to draw up a precise diagnosis of their greenhouse emissions in line with the French Environmental Code.

Finally, the financing of the green industry is an objective with considerable impact on alternative investment funds and fund managers in France. This has led to various measures, including amendments to certain rules applicable to life insurance contracts and retirement savings (in order to direct these savings towards unlisted investments) and improvement of the French legal rules governing certain investment funds (so as to facilitate their eligibility for the ELTIF label created by Regulation (EU) No 2015/760 of the European Parliament and of the Council of 29 April 2015, as amended by Regulation (EU) No 2023/606 of 15 March 2023). These are discussed in more detail below.

Amendment to Life Insurance Contracts and Retirement Savings

The life insurance industry in France is a cornerstone for personal savings, offering individuals a tax-efficient way to invest for the future while providing financial security for beneficiaries. It is dominated by large insurance groups and banks, offering diverse contracts ranging from traditional guaranteed-return products to unit-linked policies tied to market performance. Regulatory frameworks, including Solvency II, ensure the industry's stability and customer protection, while tax advantages drive its popularity. However, by end of 2023, only 7% of life insurance contracts savings were invested in unlisted securities.

The Act intended to make policyholders more aware of the challenges of the green economy and encourage them to invest in the ecological transition. To this end, various measures have been adopted:

- the creation of a new climate saving plan;
- the introduction of a minimum share of green investments in life insurance contracts; and

- the introduction of a minimum compulsory share of investment in unlisted assets in life insurance contracts and retirement savings plans.

New climate savings plan

A new savings plan for individuals of less than 21 years old the (*plan d'épargne avenir climat*, or PEAC), has been created to support the financing priorities of the French economy and the ecological transition. The PEAC may be distributed by banks and insurance companies. It takes the form of a capitalisation contract distributed by insurers or a securities account combined with a cash account.

Payments made into the PEAC are allocated to the acquisition of financial securities that contribute to the financing of the ecological transition, as well as financial instruments with a low level of risk exposure and whose issuers have their registered office in France, in another EU member state or in another state party to the Agreement on the European Economic Area that has entered into an administrative assistance agreement to combat tax fraud and evasion.

The PEAC benefits from favourable income taxation and social security contributions. The existence of this new savings plan does not substantially affect private equity fund managers, but it does demonstrate the public authorities' determination to raise awareness of the challenges of the ecological transition.

Minimum share of green investments in life insurance contracts

The Act introduced a general reference obligation regarding certain unit-linked (*unités de compte*) life insurance contracts that have obtained government-recognised labels meeting ecological transition or socially responsible investment objectives. It requires life insurance contracts to include at least one unit-linked contract made up of 5% to 10% securities issued under government-approved labels. The decree setting out the list, and which issues procedures and criteria for state-recognised labels for financing the energy and ecological transition or for socially responsible investment (adopted on 13 December 2023 – *Décret* 2023-1180), refers to two labels:

- the *Investissement Socialement Responsable* (ISR) label, whose main criteria are an elimination of the 20% worst values from an investment universe as well as certain commitment obligations (the ISR label is governed by Decree 2016-10 of 8 January 2016); and
- the *France finance verte* (Greenfin) label, which consists of a minimum percentage of investment in sustainable sectors (energy, construction, waste management, industry, etc) and exclusions (coal, gas, nuclear) (the Greenfin label is governed by the Environmental Code).

These two labels are currently under review. Additional labels may be added in the future.

This measure will encourage fund managers to set up private funds eligible for either ISR or Greenfin labels. However, these labels may not be available for all alternative investment strategies: most ISR labels are granted to real estate funds, and most Greenfin labels are granted to infrastructure funds.

Minimum compulsory share of investment in unlisted assets in life insurance contracts and retirement savings plans

The Act gives policyholders easier access to unlisted assets in order to help finance the green industry. The Act makes it compulsory for life insurance contracts and retirement savings plans to hold a minimum proportion of unlisted assets. This initiative marks a turning point in savings management. Retirement savings and life insurance contracts will have to include a proportion of unit-linked invested in non-listed assets, which helps the financing of the decarbonisation of small and medium-sized enterprises (SMEs) and intermediate-sized enterprises (*entreprises de taille intermédiaire* – ETIs).

The Act require insurers to offer a managed life insurance contract, by means of an arbitrage mandate, which includes a minimum proportion of unlisted assets. By directing a portion of life insurance savings towards unlisted assets, the Act hopes to steer more investors towards companies and projects that make a tangible contribution to the real economy. Two implementing orders (*arrétés*) of the Act, dated 1 July 2024, have been enacted and specify the terms and conditions of this arbitrage mandate (also called an insurer's guided solution (*gestion pilotée*)). The guided solutions proposed by insurers depend on the risk profile chosen by the policyholder from among the following:

- prudent;
- balanced; and
- dynamic.

Each profile entails the following minimum allocation to unlisted assets (such unlisted assets include alternative investment funds eligible for unit-linked life insurance contracts):

- prudent, 0%;
- balanced, 4%; and
- dynamic, 8%.

For retirement savings, the risk profile chosen by the policyholder could include an offensive profile (in addition to the three profiles described above). The minimum allocation to unlisted assets depends on the risk profile and on the investment horizon chosen by the policyholder (for example, an investment of more than 20 years with an offensive profile entails a minimum allocation to unlisted assets of 15%).

As an implementing measure of the Act, two decrees published on 5 July 2024 (Decrees No 2024-713 and No 2024-714) and applicable as of 24 October 2024 modernise the investment universe for life insurance, capitalisation and retirement savings plans by expanding the list of assets eligible for life insurance contracts and retirement saving plans to include specialised financing funds (*organisme de financement spécialisés*, or OFS), and facilitating the conditions for subscribing to unit-linked representing ELTIFs.

Certain French private alternative investment funds commonly used to invest in unlisted companies, such as FPCI (*fonds professionnel de capital investissement*), FPS (*fonds professionnel spécialisé*) and SLP (*sociétés de libre partenariat*) can be included in unit-linked life insurance contracts if they comply with the following conditions:

- these funds must comply with the 50% investment quota referred to in Articles L214-28 and L214-159 of the French Monetary and Financial Code (FMFC);
- the policyholders must be considered, after evaluation, to have the experience, knowledge and competence necessary to make their own investment decisions and correctly assess the risks incurred, and must allocate a premium of at least EUR100,000 for investing through the unit-linked life insurance contracts in such funds; and

- such premium cannot exceed 50% of the life insurance contract's assets.

OFS are now eligible for unit-linked life insurance contracts under the same conditions as FPS, FPCI and SLP. The premium of minimum EUR100,000 has been lowered to EUR5,000 if the investment through the unit-linked life insurance contract is made as part of an arbitrage mandate. If the FPS, SLP and OFS benefit from the ELTIF label, the condition relating to compliance with the above-mentioned 50% investment quota is no longer required. If the FPCI, FPS, SLP and OFS benefit from the ELTIF label and are opened to retail investors, the conditions regarding the experience and knowledge as well as the minimum premium of EUR100,000 are no longer required. Assets eligible for retirement savings plans have been expanded to include FPCI, FPS, SLP, OFS and ELTIFs under the same conditions as those described above for unit-linked life insurance contracts.

Life insurance contracts and retirement savings are likely to become a preferred distribution channel for fund managers currently struggling with fundraising towards institutional investors. However, this will force fund managers to structure investment vehicles that are compatible with the constraints governing life insurance contracts and savings plans – ie:

- funds eligible for being unit-linked;
- funds that benefit from a recognised green label or that are otherwise directed towards green investments; or
- funds that benefit from the ELTIF label.

ELTIF 2.0 transposition, and improvement of the structuring of French investment funds

The Act supports the development of ELTIFs in France. ELTIFs are alternative investment funds that pursue the objective of raising capital and channelling it into long-term European investment in the real economy, in line with the EU's objective of smart, sustainable and inclusive growth. ELTIFs can be marketed to retail (non-professional) investors or to professional investors only.

The ELTIF Regulation does not create a new category of fund vehicles. Its rules are applicable in parallel with legal forms of fund vehicles recognised by national laws, without replacing them. Therefore, a French vehicle must have a legal regime compatible with ELTIFs in order for such vehicle to benefit from the ELTIF label. In this context, the Act empowers the government to legislate by ordinance, in order to adapt French law to ELTIF requirements and modernise the range of French alternative investment funds. Such ordinance was enacted on 3 July 2024 (*Ordonnance*2024-662 – the "Ordinance") and contains simplification and modernisation measures designed to make the French legal framework more attractive. These measures consist of the creation of a new vehicle, the *société de libre partenariat spéciale* (SLPS) and the enactment of new structuring options for French investment funds (see the following).

Creation of a new fund vehicle

In order to improve the attractiveness of French funds, especially for non-French investors, a French investment fund called the *société de libre partenariat* (SLP) (mirroring the functions of limited partnerships, with a general partner and limited partners) was introduced into French law in 2015. The SLP has a legal personality unlike certain non-French limited partnerships. The Ordinance also introduced a new form of unincorporated SLP, the SLPS (as mentioned above), which does not have legal personality. However, an SLPS needs to be registered with the commercial trade register as an SLP. SLPS basically share the same functions and flexibility as SLP.

New structuring options for French investment funds

The new structuring options introduced by the Ordinance are directed both to French investment funds dedicated to professional investors and to those dedicated to retail investors.

New structuring options for French investment funds dedicated to professional investors

French investment vehicles dedicated to professional investors (see the MiFID definition), and commonly used for investing in unlisted assets, include FPS, FPCI, SLP, SLPS and OFS.

The Ordinance extended the possibility of issuing debt instruments to certain French professional funds. Prior to the reform, only OFS benefited from this possibility. According to the Ordinance, FPS, SLP and SLPS can issue debt instruments (bonds, convertible bonds). The introduction of this structuring option is intended to make French investment funds more attractive to international institutional investors who are subject to specific constraints (particularly with regard to the application of the Solvency II Directive) and who wish to structure their investments in the form of debt securities rather than units, equity or shares. This could open up new opportunities for fund financing (such as NAV financing or hybrid financing).

The Ordinance enables FPS, SLP and OFS to create units, shares or debt instruments, giving rise to different rights on all or part of the fund's assets or its proceeds. This means that these funds may issue tracking units, shares or debt securities reflecting the economic performance of a given asset or category of assets of the fund's portfolio. However, this differentiation must not constitute a securitisation transaction within the meaning of Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 (the "Securitisation Regulation"). This could open up new opportunities for tailor-made investment solutions for certain investors that are in line with their own constraints (excuse rights, preferential exposure to certain assets, etc).

The Ordinance removes from Article L 214-154 of the FMFC two of the three previous eligibility criteria for "assets" into which an FPS (including an SLP) may invest, and relating to the absence of collateral, the valuation of the asset and its liquidity. This gives greater freedom in composition of assets, and ensures compatibility with the ELTIF Regulation. All that remains is the condition relating to proof of ownership of the asset.

New structuring options for French investment funds dedicated to retail investors

The *fonds commun de placement à risque*, or FCPR, is a French alternative investment fund dedicated to retail investors and is commonly used to invest in unlisted assets. At least 50% of an FCPR's assets must comply with the eligibility requirements set forth in Article L 214-28 of the FMFC (this covers unlisted equity and equity-like securities issued by companies and under certain conditions, shareholder loans and unlisted debt instruments). Among these criteria, the FCPR's eligible assets may also include rights representing a financial investment issued on the basis of French or foreign law in an entity whose main purpose is to invest, directly or indirectly, in companies whose equity securities are not admitted to trading on a market. These rights were included in the fund's 50% investment quota only up to the percentage of direct investments made by this entity in companies eligible for that same quota. The Ordinance permits inclusion in the 50% investment quota of the percentage of indirect investments made by such entities. This greater flexibility would facilitate the creation of funds of funds dedicated to retail investors.

The 50% investment quota must be complied with by no later than the end of the financial year following the financial year during which the FCPR was set up, and until the end of the FCPR's fifth financial year. The Ordinance introduced a derogation applicable to FCPR that benefit from the ELTIF label; the date by which such quota must be complied with will be the one set forth in the ELTIF Regulation.

In conclusion, the Green Industry Act marks a pivotal step in France's commitment to achieving sustainable industrial growth, while addressing the challenges of climate change. By combining robust financial incentives, targeted support for innovation and frameworks to attract private investment, the Act seeks to position France as a leader in the global green economy. The Act presents significant opportunities for private equity fund managers, positioning them as key players in driving the green transition. Fund managers can leverage these advantages to diversify portfolios and capitalise on the growing demand for green investments from life insurance companies and retirement savings institutions. As its measures take effect, the Act promises to drive the transformation of French-based investment funds towards more attractive investment offerings.

GERMANY

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Law and Practice

Contributed by:
Amos Veith, Jens Steinmüller, Ronald Buge and Stephan Schade
POELLATH

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Contributed by: Amos Veith, Jens Steinmüller, Ronald Buge and Stephan Schade, **POELLATH**

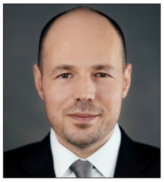
POELLATH has one of the largest and most experienced fund structuring practices in continental Europe, with locations in Berlin, Frankfurt and Munich, and around 60 professionals. It is a market leader in the structuring of private equity funds in Germany, and maintains strong relationships with local law firms in jurisdictions outside the country. The firm advises initiators of, and investors in, private equity funds and worldwide fund participations in the area of alternative investments. The team has extensive expertise in fund structuring; advice regarding the Alternative Investment Fund Managers Directive (AIFMD), the German Capital Investment Act (KAGB) and the Markets in Financial Instruments Directive II (MiFID II); asset management; and secondary transactions. This includes all relevant fund structures in private equity, mezzanine/private debt, distressed debt, real estate, infrastructure, natural resources/energy, education, hybrid funds, hedge funds, crypto/digital assets funds, captive funds, master-feeder structures, separate accounts, GP-led continuation funds and specialised funds, as well as primary and secondary funds of funds.

Authors

Amos Veith is a partner and the co-head of the private funds department at POELLATH. He provides fiscal and legal advice to domestic or foreign institutional and private investors and initiators in the areas of private equity funds and funds of funds in the private equity, mezzanine and secondaries sectors. His publications include articles on the taxation of investments and the regulatory and tax aspects of fund structures. He is the editor of the Frankfurt commentary on private equity. Amos has an LLM degree and has authored and co-authored several articles, including recently in the Private Equity and Venture Capital Funds handbook.

Jens Steinmüller is a partner and co-head of the private funds team at POELLATH, and advises on fund-related legal, regulatory and tax issues. He has particular experience in developing tailor-made approaches to alternative investments, with a focus on German insurance companies, pension funds and banks investing directly, via a fund of funds or via managed account structures. He frequently contributes to the work of professional bodies and has written numerous articles relating to investment funds. Jens is also a co-editor of a commentary regarding the new German Investment Fund Tax Act, and a member of the advisory board of a German journal on legal topics relating to financial instruments.

Ronald Buge is a partner in the private funds practice group at POELLATH. He advises fund managers on legal and tax matters relating to the structuring of alternative investment funds; he also advises institutional investors such as insurance companies and pension funds, as well as family offices, in connection with investments in such funds. Ronald focuses on German and international tax law, including investment tax law, procedural law and tax compliance issues (FATCA, CRS and DAC 6). He is the author of a commentary on the German Income Tax Act and the German Investment Tax Act, and frequently publishes abstracts on tax law in several legal journals.



Stephan Schade is a partner in the private funds practice group at POELLATH. He advises well-known German and foreign clients on all aspects of contract, regulatory and tax law in fund structuring and fund investments, as well as fund secondaries and GP-led transactions. His focus is on fund compliance advice, particularly in the areas of data protection, money laundering prevention and regulatory reporting requirements. Stephan has contributed to many publications in his areas of expertise, including several articles in the Private Equity and Venture Capital Funds handbook. He is also an author in a C H Beck commentary regarding the KAGB, which implements the AIFMD into German law.

POELLATH

Potsdamer Platz 5
10785 Berlin
Germany

Tel: +49 3025 3530
Fax: +49 3025 3530
Email: ber@pplaw.com
Web: www.pplaw.com

POELLATH+

1. Market Overview

1.1 State of the Market

Germany is frequently used by advisers and managers for the formation of venture capital, private equity and similar closed-end alternative investment funds, as well as for retail funds whenever the manager of the respective investment fund is located in Germany – ie, Germany is generally not used as a domicile for structuring alternative investment funds or retail funds by non-German advisers or managers. Typically, German private equity or venture capital funds are structured as limited partnerships that are transparent for German tax purposes.

German resident institutional investors and German family offices are frequent targets of fundraising activities for venture capital, private equity and similar alternative investment funds located in Germany or various other jurisdictions around the world.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

The typical legal forms of investment funds used in Germany are limited partnerships, investment stock corporations and contractual funds with no legal personality of their own (*Sondervermögen*). The most frequently used legal form for private funds is the limited partnership, whereas retail funds, undertakings for the collective investment in transferable securities (UCITS) funds and real estate funds are more often structured as contractual funds. A key difference is that a limited partnership is transparent for German tax purposes, whereas the rules of the German Investment Tax Act apply in respect of corporate fund structures and contractual funds treating such funds as opaque entities.

2.1.2 Common Process for Setting Up Investment Funds

The process for setting up an investment fund in Germany differs for registered sub-threshold managers and fully licensed managers of alternative investment funds. The regulation of investment funds in Germany is primarily exercised through the regulation of the respective manager, who is required to apply for a full licence or to be registered with the German supervisory authority for financial services (BaFin) under the German Investment Code (KAGB). The KAGB implements the European Alternative Investment Fund Managers Directive (AIFMD) rules into German law.

Registered Managers – Registration Process

Availability

This registration process is available to certain small or medium-sized managers only. The most important category of these small to medium-sized managers is known as a “sub-threshold manager” under the AIFMD and KAGB. In practice, most German alternative investment fund managers outside the real estate area still fall within this category.

Sub-threshold managers under the KAGB are managers with assets under management of not more than EUR500 million with no leverage at fund level, or not more than EUR100 million if there is leverage at fund level, and who manage so-called special alternative investment funds (“Special AIFs”) only. Special AIFs are AIFs whose interests or shares may only be acquired by professional investors or semi-professional investors (ie, non-retail funds).

Registration procedure

The registration process is relatively simple. It requires the submission of a registration request together with certain documents on the manager and the investment fund(s) the manager intends to manage (such as the fund's anticipated strategy and investor base and the manager's articles of association). In addition, a Special AIF may not require the investors to pay in capital in excess of their respective original capital commitment.

Ongoing compliance issues

An advantage of the registration is that only a few provisions of the KAGB apply to "registered-only" managers – mainly the provisions on the registration requirements, some ongoing reporting requirements and the general supervisory powers of BaFin. However, fund-specific requirements do not apply to "registered-only" managers and their funds. In particular, the depository requirements and marketing requirements do not apply, nor do the additional requirements of the KAGB for fully licensed managers, except that certain additional internal governance and reporting obligations apply to the extent that any debt funds are managed.

In exchange for such light regulation, "registered-only" managers do not benefit from the European marketing passport under the AIFMD. A registered manager can, however, opt to become a fully licensed manager (or upgrade to be a European Venture Capital Fund (EuVECA) manager). Since 2021, "registered-only" managers have been required to audit their annual financial statements. Such audit must include a review of compliance with the KAGB and German anti-money laundering law.

Fully Licensed Manager – Licensing Process

Availability

Fund managers who do not qualify for a registration or who opt to upgrade must apply for a full fund management licence with BaFin under the KAGB. A full fund management licence opens a door for managers to market funds to retail investors, and also gives access to the marketing passport under the AIFMD. Retail investors are neither professional nor semi-professional investors.

Licensing procedure

The licensing procedure is a fully fledged authorisation process with requirements equivalent to the requirements for granting permission under Article 8 of the AIFMD or Article 6 of the UCITS Directive. The licensing procedure checks requirements such as sufficient initial capital or owned funds, adequate experience of the directors, sufficiently good repute of the directors and shareholders, and organisational structure of the manager.

Ongoing issues

The licensing of the manager results in the manager being subject to the entirety of the KAGB, which entails the following in particular:

- the appointment of a depositary for the funds;
- access to setting up contractual funds;
- adherence to the corporate governance rules for funds set up as investment corporations or investment limited partnerships (so-called Investment KGs);
- adherence to the fund-related requirements of the KAGB;
- adherence to the pre-marketing and marketing rules of the KAGB;
- access to the marketing passport under the AIFMD or UCITS Directive;

- access to the managing passport under the AIFMD or UCITS Directive; and
- adherence to the reporting requirements of the KAGB.

2.1.3 Limited Liability

Investors admitted to investment funds in Germany typically benefit from limited liability. As limited partners of a limited partnership, which is the most frequently used structure for alternative investment funds in Germany, their liability in relation to third parties for obligations of the fund is limited to their respective liability amount registered with the commercial register of the respective fund partnership. The liability amount is typically a small portion (ie, 0.1%) of their capital commitment or a small fixed amount. Once this portion of their capital commitment has been contributed to the alternative investment fund, their liability in relation to third parties ceases to exist.

Regarding the relationship of the investors to the alternative investment fund itself, the liability is restricted to the unpaid portion of the investor's capital commitment. For fund structures other than limited partnerships, an even stricter limitation of liability applies. Legal opinions are commonly issued to confirm such limitation of liability.

2.1.4 Disclosure Requirements

For the usual AIFs that are marketed to non-retail investors, there is no legal requirement to issue a private placement memorandum (PPM); however, all fund managers are subject to the SFDR disclosure obligations and disclosures under Article 23 of the AIFMD must be provided if the fund is marketed under the AIFMD. In any case, a PPM is commonly produced for all AIFs to ensure that the investors are informed – completely and correctly, and in a non-misleading manner – about the respective AIF, its management, its investment strategy, the risks associated with an investment and the expected tax consequences of the investment. These disclosures are recommended in order to avoid the liability of the sponsor or managers under general prospectus liability rules.

If the fund is marketed to semi-professional investors, a key information document must be produced.

There are annual reporting requirements for managers of retail funds and managers of non-retail funds. There are also semi-annual reporting requirements for contractual funds and investment stock corporations (AG) with variable capital. The reports need to be published.

Furthermore, notification requirements implementing Council Directive (EU) 2018/822 for cross-border tax arrangements apply for intermediaries of funds (usually the fund manager).

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

During the last two decades, alternative funds have experienced a considerable and increasing capital inflow from German institutional investors. A significant portion of the institutional investors are professional pension schemes (*berufsständische Versorgungswerke*), insurance companies, tax-exempt or taxable pension funds (*Pensionskassen*, *Pensionsfonds*) and, increasingly, banks. Furthermore, industrial companies can be found as investors in alternative investment funds, especially in specialised private equity or venture capital funds, which promise strategically interesting investment opportunities. Finally, public investors (*öffentlich-rechtliche Geldgeber*) invest in alternative funds, often motivated by reasons of broader structural economic policy.

Rather than investing directly, institutional investors often invest through managed accounts set up as single or group investor funds.

2.2.2 Legal Structures Used by Fund Managers

Legal structures depend on investors' specific requirements and preferences. The legal structures for private funds in which most types of investors are usually prepared to invest are limited partnerships and, particularly regarding real estate, contractual funds. However, specific structural requirements apply for certain types of investors.

For example, certain non-taxable or tax-exempt investors, including pension funds (*Pensionskassen*), can only invest in business-type partnerships if certain conditions and thresholds are met. Investments by investment funds intending to be treated as tax-transparent (*Spezial-Investmentfonds*) have to check the eligibility of investments in closed-end funds on a case-by-case basis. Generally, feasible ways exist for *Spezial-Investmentfonds* to invest in partnerships as well as corporate or contractual fund structures, subject to certain restrictions and thresholds.

Based on applicable product requirements, investments by *Spezial-Investmentfonds* via corporate funds or holding vehicles might be challenged, depending on the respective *Spezial-Investmentfond's* share in such fund or holding vehicle. Statements by the Federal Ministry of Finance confirm that interests in alternative funds in general can be treated as eligible investments for *Spezial-Investmentfonds* if they qualify as transferable securities under the UCITS Directive.

German pension funds that are subject to German domestic insurance regulation (Solvency I investors) usually prefer investment funds that are managed by a regulated manager. Requirements regarding the provenance and regulatory status of the fund depend on the classification of the fund. For private equity funds, fund vehicles and managers that have their seats within an EU/EEA country or Organisation for Economic Co-operation and Development (OECD) member state and that have a manager regulation that is at least comparable to the regulation of a sub-threshold alternative investment fund manager (AIFM) are sufficient. For a fund to qualify as a private equity fund, it needs to be closed-ended and may only invest in certain types of corporate finance instruments. Funds with investment policies covering instruments beyond equity and equity-like instruments require special scrutiny in this respect. For all other types of funds, only EU/EEA vehicles with full-scope AIFMs with an EU/EEA seat are eligible as AIF investments.

Interests in closed-end funds held by Solvency I investors or Solvency II investors need to be transferable without the prior consent of the general partner, manager or any other investor, as long as the interests are transferred to another institutional (or other creditworthy) investor. At the same time, the fund documents might need to contain specific language clarifying that an interest can only be transferred upon the prior written consent of a trustee appointed by the investor to safeguard the investor's assets, dedicated to covering a client's claims against the insurer.

2.2.3 Restrictions on Investors

There are no general restrictions for investors investing in investment funds. However, certain restrictions apply to specific types of investors – eg, Solvency I investors may not invest in investment funds that directly invest in working capital or consumer credits.

German insurance companies (Solvency II investors) have certain transparency requirements due to the prudent person principle under Solvency II. Investors usually require look-through information on the basis of a standardised tripartite reporting template. Moreover, Solvency II investors are subject to capital requirements, which are determined by risks in connection with investments, among other factors. Unleveraged closed-end funds are privileged in that respect.

Due to rules implementing further Basel III rules in 2021, fund managers must also accommodate the increasing transparency requirements of the growing group of banks reaching out for investments in AIFs – eg, in order to avoid investing banks having to fully back their investments with regulatory own funds (funds that institutions must have to absorb losses and comply with EU legislation).

Last but not least, ESG concerns are on the agenda of an increasing number of investors. Some institutional investors are already subject to statutory ESG obligations – eg, pension funds have to consider ESG aspects in connection with their business organisation and risk management, and are obliged to be transparent with regard to their handling of ESG factors. Solvency II investors have to consider sustainability aspects as part of the prudent person principle.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

BaFin is responsible for regulating funds and fund managers.

In Germany, the management of investment funds is regulated by the KAGB, which implements the AIFMD and the UCITS Directive. The law requires that the manager is fully licensed or registered with BaFin under the KAGB. If a fund is internally managed, then the fund itself needs a licence or registration.

For details on investment limitations and other rules applicable to alternative funds, see **2.4 Operational Requirements**.

2.3.2 Requirements for Non-Local Service Providers

There is, in general, no registration or regulation requirement for non-local service providers such as administrators, custodians and director services providers. However, when a German manager outsources portfolio or risk management, the delegate must be authorised or registered in their home country. In addition, any delegate domiciled outside of the EU must appoint a domestic authorised agent to whom notifications and service of process can be effected by the respective German authority.

An outsourcing delegate who provides services falling under the Markets in Financial Instruments Directive (MiFID) will be subject to a licence requirement under the German Banking Act (KWG) or the recently introduced German Securities Institutions Act (WpIG) if they actively solicited the relationship with the manager (as opposed to reverse solicitation). Acting as tied agent for such services is also possible.

If German regulatory law requires a depositary for a German AIF, the depositary – or at least a branch of the depositary – must be domiciled in Germany.

2.3.3 Local Regulatory Requirements for Non-Local Managers

EU Fund Managers

EU fund managers are allowed to perform fund management services under the AIFMD passport regime with regard to German Special AIFs.

They may also use the AIFMD passport to provide other services and ancillary services (such as MiFID investment advice or discretionary individual portfolio management).

Non-EU Managers

Non-EU managers are currently not allowed to perform fund management services in Germany. This might change in the future with regard to AIFMs in those countries for which the passporting regime under the AIFMD for third-country managers will eventually become effective.

Outside of providing fund management services (eg, managed account solutions), non-EU managers may provide certain regulated services in Germany, such as investment advice or discretionary individual portfolio management. This requires either that the services are in the scope of an existing relationship with the German manager or that the relationship is established at the initiative of the German client (reverse solicitation). As an alternative, such service providers may apply to BaFin for an exemption from the German licence requirements (which is a lengthy process).

2.3.4 Regulatory Approval Process

The registration procedure for a sub-threshold manager is comparatively simple and takes about one month. A full licensing procedure varies between six and 12 months, or even more. For the details on registered and fully licensed managers, see **2.1.2 Common Process for Setting Up Investment Funds**.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

A stricter regulation of pre-marketing activities and of the content of marketing materials has applied since the harmonised European regime for pre-marketing of alternative investment funds came into force in August 2021 (Directive (EU) 2019/1160 and the related Regulation (EU) 2019/1156)). The European marketing regime provided by the EU Directive only applies to marketing activities by, or on behalf of, EU managers.

The German Implementation Act, however, extends the EU pre-marketing rules to non-EU managers. The commencement of pre-marketing of an AIF in Germany by a German or non-German manager (except for "registered-only" managers) needs to be notified to BaFin directly or through the respective regulator of an EU manager, and any subscription by German investors within 18 months following the commencement of pre-marketing will require adherence to the formal marketing notification and, thus, precludes reverse solicitation.

2.3.6 Rules Concerning Marketing of Alternative Funds

Germany understands marketing activities to be any direct or indirect offering or placement of units or shares in an investment fund. Reverse solicitation is currently not regarded as marketing, but its scope is further limited due to the pre-marketing regime.

Marketing materials must be in line with the European Securities and Markets Authority (ESMA) guidelines on the fair and not misleading standard of the content of marketing materials. These guidelines mirror the rather strict rules under the MiFID regime.

For placement activities in Germany by EU "registered-only" or non-EU managers, the BaFin FAQs maintain the position that placement by a manager, in particular, takes place with regard to a fund if:

- the fund has been established (ie, first closing with investors); or
- the terms of the fund are ready to be sent for acceptance to investors.

Such FAQs also stipulate that reverse solicitation – ie, the approach of a manager by a German investor on its own initiative – will be permissible even on the basis of general advertisement activities of such manager if unrelated to particular funds.

2.3.7 Marketing of Alternative Funds

AIFs can basically be marketed to retail and non-retail investors. However, alternative funds that are closed-end Special AIFs can only be marketed to professional and semi-professional investors. The EuVECA regime and the European long-term investment funds (ELTIF) regime apply to the marketing of EuVECA funds and ELTIF funds in the EU and in the EEA.

2.3.8 Marketing Authorisation/Notification Process

The marketing of alternative funds requires an authorisation by BaFin or at least a European marketing passport under the AIFMD, except for marketing by German sub-threshold managers.

Depending on the type of investment fund and whether retail investors are targeted, the notification process and the materials to be presented to BaFin vary.

To the extent an EU-AIFM has notified the marketing of an AIF in Germany to its local regulator, BaFin generally only reviews whether the notification and materials provided by such local regulator are complete, and marketing may already commence when such local regulator has informed the EU-AIFM of the submission to BaFin.

2.3.9 Post-Marketing Ongoing Requirements

As explained in **2.1.4 Disclosure Requirements**, there are annual reporting requirements for managers of retail funds and managers of non-retail funds. There are also semi-annual reporting requirements for contractual funds and AG with variable capital. The reports need to be published.

2.3.10 Investor Protection Rules

As explained in **2.3.1 Regulatory Regime**, Germany recognises the concept of Special AIFs, which are AIFs whose interests or shares may only be acquired according to the fund documents by professional investors within the meaning of the AIFMD or by semi-professional investors. Special AIFs themselves are either subject to a lighter regulatory regime than retail funds (in the case of fully licensed managers) or are not subject to a regulatory regime at all (in the case of a German sub-threshold manager, except for debt funds).

2.3.11 Approach of the Regulator

In the authors' experience, BaFin is generally co-operative and open to discussions. Expected timeframes can sometimes be an issue, particularly where BaFin is requested to answer questions on new issues.

BaFin regularly takes enforcement actions, with enforcement usually being a proportionate, step-by-step approach. Often, BaFin just issues a request for explanations as a warning and takes further actions only if the answers are not satisfactory.

2.4 Operational Requirements

The investment-type restrictions for regulated general special funds translate only into assets that can be valued at fair value and risk diversification. In practice, regulated special funds are often set up under a specific fund category (eg, special funds with fixed investment guidelines). Accordingly, for these funds, investment-type restrictions apply based on the chosen fund category and individualised investment guidelines (eg, real estate focus or debt fund).

Borrowing restrictions depend on the chosen fund category. For instance, special funds with fixed investment guidelines allow short-term borrowing of up to 30% of their net asset value and, for real estate, up to 60% of the real estate value. For German debt funds, the borrowing restriction is 30% of the capital available for investment.

If the fund manager is fully licensed, they must appoint a depositary or special private equity custodian for each of its funds (as required by the AIFMD).

The valuation and pricing of the fund's assets must be in line with the AIFMD requirements – ie, fair value.

The operational requirements of a fully licensed manager are in line with the AIFMD. In addition, fund managers must adhere to rules that apply to all market participants, such as the EU-based rules on insider dealing and market abuse, transparency, money laundering and short selling. Special internal rules apply to the manager ("manager-internal rules") regarding debt funds.

Sub-threshold managers are only subject to a light-touch regulatory regime. Accordingly, no operational requirements apply, in principle, from a regulatory perspective (except with regards to debt funds).

2.5 Fund Finance

Accessibility to Borrowing for Funds

Funds that are eligible for non-trading treatment from a tax perspective (see also **2.6 Tax Regime**) are generally not permitted to raise debt at fund level nor to provide guarantees or other forms of collateral for the indebtedness of portfolio companies. As an exception, tax authorities have accepted that funds can enter into a capital call facility subject to certain restrictions, and the number of funds making use of this concession has increased, as has the number of financial institutions offering capital call facilities to German funds. Leverage is not permitted for tax reasons and is restricted for regulatory reasons.

Restrictions on Borrowings

The criteria for non-trading treatment from a tax perspective do not allow borrowings at fund level. As an exception, short-term borrowings to bridge capital calls are accepted by tax authorities. While "short-term" has not been defined, borrowings cannot remain outstanding for more than 270 calendar days. Fund managers need to first issue the capital call and can thereafter draw down the amount under the capital call facility. The amount so borrowed is then repaid out of the capital contributions.

Lenders Taking Security

Under German law, the investors' commitment to the capital of a fund is not an asset that can be pledged in favour of the capital call facility provider. As a consequence, capital call facility agreements entered into by German funds typically provide that payments of capital contributions shall be made to a bank account maintained with the facility provider that is pledged in its favour. In addition, the facility provider reserves the right to claim payment of capital contributions directly from investors when due, and to enforce the fund's rights under the fund agreement in the event of default. Assets and investments held by the fund are typically not pledged as collateral.

Common Issues in Relation to Fund Finance

Common issues include the following:

- financial covenants regarding excused investors in respect of an investment by reference to the number of excused investors and the total amount; and
- default situations pending at the time of a drawdown under the facility agreement by reference to the number of defaulting investors and the total amount.

Investors typically object to the requirement to provide financial information unless publicly accessible.

Because of the general restriction on providing guarantees and other forms of collateral for the indebtedness of portfolio companies, equity commitment letters are very often used as an alternative. They should not interfere with the general restrictions on providing guarantees if structured as an agreement between the fund and its portfolio company whereby the fund undertakes to provide additional capital in the event that the portfolio company is in payment default or in breach of financial covenants. Such undertaking, however, should not be pledged by the portfolio company in favour of its creditors, in order to avoid being treated as a guarantee of the fund. The portfolio company can undertake in the agreement with its creditors not to change, amend or waive the fund's equity commitment letter other than with the consent of its creditors.

2.6 Tax Regime

The tax regime applicable to fund structures depends on whether a fund is organised as a corporate entity or a partnership.

Funds Organised as Partnerships

The tax regime applicable to funds organised as partnerships is as follows.

Fund structures

Consistent with international standards, German funds are typically structured as partnerships that are eligible for non-trading treatment and avoid their investment activities constituting a trade or business attributable to a permanent establishment. The non-trading requirements for private equity and venture capital funds are set out in an administrative pronouncement and include the following:

- no borrowings and guarantees on fund level (other than fund finance, as described in **2.5 Fund Finance**);
- no reinvestment of proceeds, subject to two exceptions:
  - (a) proceeds up to an amount previously drawn down to fund management fees and fund expenses can be reinvested to ensure that an amount representing 100% of the total capital commitments can be invested in portfolio companies; and
  - (b) an additional amount not exceeding 20% of the total capital commitments can be reinvested to fund follow-on investments;
- a weighted average holding period of investments of at least three years; and
- no involvement in the operating management of portfolio companies whereby representation on the supervisory or advisory board of portfolio companies in a non-executive, monitoring capacity is permitted.

However, the administrative pronouncement has been questioned by the courts and the tax authorities of some federal states seemed to have changed their view on the administrative pronouncement and interpret some of the requirements in a more narrow manner. For this reason, and to avoid some of the restrictions associated with the requirements, certain fund managers tend to set up funds that are treated as trading partnerships.

As of 2024, management of private equity and venture capital funds by German managers is no longer subject to VAT in Germany.

Allocations and distributions to investors

Funds structured as partnerships are treated as transparent for German tax purposes, so taxable income allocated to the investors is subject to tax regardless of whether or not the fund made distributions. Non-resident investors of funds that are eligible for non-trading treatment are generally not subject to a German tax filing obligation in respect of their allocable share of the fund's taxable profit while non-resident investors of a trading fund must file a tax return in Germany. To handle this, some investors interpose holding companies that are opaque for German tax purposes or use corporate (opaque) feeder structures.

Regardless of whether the fund is a trading or non-trading partnership, the fund files a partnership return showing the items of taxable income received by the fund partnership and each investor's allocable share thereof. In case of a non-trading fund partnership, non-resident investors are included in the partnership return only for information purposes. They are subject to tax in their country of residence in accordance with their personal tax status. In case of a trading fund partnership the income of non-resident investors will be determined based on the partnership return. The income so determined is binding for the tax assessment procedure of the non-resident investors.

Distributions by the fund to investors are not subject to German withholding tax. Dividends received by the fund from German portfolio companies as well as payments by German portfolio companies on certain German-source profit-linked debt instruments (such as silent partnership interests, jouissance rights and profit-sharing loans) are subject to withholding tax at the rate of approximately 26.4% (including solidarity surcharge) at source. Generally, the withholding agent (German portfolio companies or a German issuer of a profit-linked debt instrument) is not permitted to apply a reduced rate of withholding (eg, under an applicable tax treaty). Non-German investors that are entitled to treaty benefits with respect to such items of income must file a refund application with the German federal tax office, which is awarded subject to the fulfilment of certain procedural requirements. However, in case of a trading fund partnership the German withholding tax can be credited against the German tax liability of a non-resident investor and an exceeding amount (if any) will be refunded upon tax assessment.

Carried interest participants

The German fiscal authorities characterise carried interest payments as a compensation for professional services, and carried interest payments are not taxed in accordance with the rules applicable to the source from which such payments are derived. Carried interest payments by private equity funds and venture capital funds that are eligible for non-trading treatment are eligible for a partial tax exemption of 40%, and the remaining 60% is subject to tax at the marginal income tax rate of the carried interest participant.

According to German fiscal authorities, carried interest payments by funds that are treated as trading are fully subject to tax at the marginal income tax rate of the carried interest participant. According to a decision rendered by the German federal tax court in December 2018, carried interest payments by funds that are treated as trading are subject to tax in accordance with the tax rules applicable to the source from which the carried interest payments are derived. It is an open issue whether this favourable court decision will be generally applied by the German fiscal authorities.

In April 2024 the German federal tax court held that these principles also apply to non-trading fund partnerships. However, as there are specific provisions on requalification and partial exemption of carried interest payments at the level of the carried interest participant, this is only relevant at partnership level. This has an impact on investors because carried interest can no longer be treated as expense at partnership level (which might be non-deductible in certain scenarios) but as (disproportional) allocation of income which reduces the income of the investors. The German tax authorities have not yet decided whether they are willing to apply the principles laid down in this decision generally.

Carried interest payments are not subject to VAT.

Taxation of Investors of Domestic and International Partnership-Type Funds

The following description is limited to funds organised as partnerships.

Domestic funds eligible for non-trading treatment

Partnership-type funds are treated as transparent for German tax purposes. Therefore, taxable income allocated to the investors is subject to tax at its level and in accordance with its tax status, regardless of whether or not the fund made distributions.

Resident corporate investors

95% of a resident corporate investor's allocable share of equity capital gains is exempt from tax; the remaining 5% and all other items of income (interest and dividends) are subject to German corporate income tax and trade tax. The 95% exemption does not apply to life and healthcare insurance companies.

Non-resident corporate investors

A non-resident corporate investor's allocable share of German equity capital gains is exempt from German tax. Dividends received from German portfolio companies and payments on certain profit-linked debt instruments by German issuers are subject to German withholding tax at the rate of approximately 26.4%. Tax treaty-protected investors may file an application with the German federal tax office for a refund of German withholding tax under the applicable tax treaty. Income derived from non-German portfolio companies is not taxable in Germany for non-resident corporate investors.

Domestic funds eligible for trading treatment

Fund that are trading partnerships are treated as transparent for German income and corporation tax purposes as well. However, they are subject to German trade tax as and of themselves.

Resident corporate investors

The taxation of resident corporate investors in trading fund partnerships is, in principle, similar to the taxation of income from non-trading funds. However, corporate investors of a domestic trading fund partnership benefit from a trade tax deduction as the fund partnership pays trade tax itself. This does not apply to life and healthcare insurance companies which have other mechanisms to avoid double trade tax burden, though.

Non-resident corporate investors

Generally, non-resident corporate investors of a domestic trading fund partnership are subject to the same tax consequences as resident corporate investors and they must file a German tax return. In particular, German withholding tax can be credited against the German tax liability of a non-resident investor and an exceeding amount (if any) will be refunded upon tax assessment.

Non-German funds

Regardless of the qualification of their investment activities, non-German funds are typically deemed to be trading from a German tax perspective due to their legal structure.

Resident corporate investors

The allocable share of a non-German (deemed) trading fund's taxable profits is subject to German tax. 95% of equity capital gains is exempt from corporate income tax and 100% is exempt from trade tax. These exemptions do not apply to life and healthcare insurance companies. The full amount of interest and dividends is subject to corporate income tax, but trade tax is levied only on interest and on dividends where the fund holds less than 10% of the company paying the dividend.

Non-resident corporate investors

The deemed trading status of non-German funds does not affect their taxation in Germany. Their allocable share of German equity capital gains is exempt from German tax. However, they may be required to file a German tax return where they have held 1% or more of the share capital of the German company, the shares of which were sold or disposed of (determined on a look-through basis) during the last five years prior to such sale or disposition. They are only subject to tax in Germany in respect of items of income derived from German sources that are subject to German withholding tax at a rate of approximately 26.4% – ie, German dividends and payments on certain profit-linked debt instruments by German issuers. Tax treaty-protected investors may apply to the German federal tax office for a refund under an applicable tax treaty.

Corporate-Type Funds

The taxation of corporate-type funds (including funds of a contractual type such as the German *Sondervermögen* and non-German fund vehicles that resemble a German *Sondervermögen*, including trusts) and their investors is governed by the German Investment Tax Act.

Fund level

A corporate-type fund is a taxpayer in and of itself. Regardless of whether its place of business management is located in or outside Germany, only certain items of German-source income are subject to tax at the level of the fund.

- German-source dividends.
- Income derived from German real estate (not dealt with herein).
- Trading income attributable to a German permanent establishment, but excluding capital gains realised upon the sale of shares of companies. However, if such shares form part of a trade or business and are attributable to a German permanent establishment, the full amount of capital gains from the sale of such shares by a corporate-type fund and

any other trading income attributable to such German permanent establishment is subject to German tax at the level of such corporate-type fund.

Investor level

Non-resident corporate investors

Distributions by corporate-type German or non-German funds to non-resident investors are not subject to (withholding) tax in Germany.

Resident corporate investors

Resident investors are subject to German tax on the following three items of income derived from a corporate-type fund:

- all distributions;
- a lump-sum advance amount that represents a minimum yield and is only subject to tax if the corporate-type fund does not make distributions equal to, or exceeding, the lump-sum advance amount; and
- capital gains realised upon the sale of shares of the corporate-type fund either in a secondary transaction with a third party or in connection with a redemption of shares or a share buy-back by the corporate-type fund.

These three items of income subject to tax at the level of resident investors are eligible for a partial tax exemption in order to mitigate double taxation at fund and investor level if the corporate-type fund qualifies as a so-called equity fund or mixed fund. An equity fund is a corporate-type fund whose binding investment guidelines provide that more than 50% of the total net assets is directly invested throughout the entire fiscal year in equity instruments issued by companies being subject to minimum taxation requirements. For a mixed fund, the relevant threshold for direct equity investments is at least 25%.

For equity funds, the partial tax exemptions for taxable resident corporate investors (other than life or healthcare insurance companies) amount to 80% for corporate income tax purposes and 40% for trade tax purposes. In respect of mixed funds, the partial tax exemptions amount to half of the exemptions applicable to equity funds.

Germany’s Tax Treaty Network and Its Impact on the Funds Industry

Germany’s tax treaty network is extensive and covers, among others, all member states of the EU and the OECD. German tax treaties generally follow the OECD Model Convention. German corporate-type funds should be eligible for protection by German tax treaties regardless of the fact that their tax bases only include certain items of German-source income. Because distributions by German corporate-type funds to non-resident investors are not taxable in Germany under German domestic tax law, non-resident investors need not rely on treaty benefits in this regard.

Funds organised as partnerships are transparent for income tax purposes. German investors benefit from Germany’s tax treaty network because the geographic focus of funds typically relates to tax treaty countries. Funds investing in Germany benefit from Germany’s tax treaty network because their fundraising very often relates to investors resident in tax treaty countries. However, virtually none of the German tax treaties provides any benefits for non-resident investors in case of income from trade or business that is attributable to a German permanent establishment. In case of trading treatment of a fund partnership from a German perspective this may give rise to mismatches in case the tax authorities of the country of residence of a non-resident investor take a contrary view.

FATCA and CRS Regimes in Germany

Germany has entered into a Model-1 intergovernmental agreement (IGA) with the USA and has incorporated the reporting and disclosure requirements under the Foreign Account Tax Compliance Act (FATCA) as modified by the IGA into German domestic law. Accordingly, German fund managers have to file information under FATCA with the German federal tax office, which exchanges such information with the US Internal Revenue Service (IRS). As a consequence, German fund managers do not have a direct obligation towards the IRS regarding FATCA reporting and disclosure.

Germany has also incorporated the Common Reporting Standard (CRS) into domestic law. As a result, German fund managers have an obligation under German domestic law to file information under the CRS with the German federal tax office, which exchanges this information with the competent tax authorities of the participating countries of the CRS.

DAC 6

The tax treatment and tax structure of partnership-type funds is typically not subject to filing requirements under DAC 6 (EU Council Directive 2011/16 in relation to cross-border tax arrangements). In particular, the trading or non-trading status of a partnership-type fund should not give rise to filing obligations under DAC 6. Moreover, the German tax authorities have provided guidance that the PPM or a similar document that outlines the risks and benefits of an investment does not constitute standardised documentation within the meaning of Hallmark A 3 of Part II of Annex IV to DAC 6.

Currently, there are discussions to extend filing requirements similar to DAC 6 to merely domestic tax arrangements. Respective legislation is still pending and it is not entirely clear if and when such filing requirements will enter into force.

The Anti-Tax Avoidance Directive (ATAD)

As Germany, like most other countries, treats partnerships as being tax-transparent, an investment in a partnership-type fund should not give rise to hybrid mismatches. However, if an investor is residing in a country that treats partnerships as opaque, any income of a German partnership-type fund attributable to such investor is subject to German tax to the same extent as if such investor were resident in Germany.

Investments in funds of a contractual type, such as the German *Sondervermögen* or non-German fund vehicles that resemble a German *Sondervermögen*, may give rise to hybrid mismatches, particularly in situations where the home jurisdiction of a non-German fund of a contractual type treats this fund as tax-transparent while Germany treats such funds as opaque under the German Investment Tax Act.

Minimum Taxation

As EU Member State Germany implemented Counsel Directive (EU) 2022/2523 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union including a qualified domestic top-up tax. However, this should not have an impact on funds themselves as they are exempted from the scope of minimum taxation as ultimate parent entities. However, special rules may apply if a fund becomes part of an MNE group subject to minimum taxation.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

As a starting point, retail investors are neither professional nor semi-professional investors (see **2.3.1 Regulatory Regime**).

Retail funds are typically set up as UCITS funds or as so-called Public AIFs (as opposed to Special AIFs). Legal vehicles are mostly contractual-type funds (*Sondervermögen*) for open-end structures, and investment limited partnerships for closed-end retail funds. Corporate structures are less common in the retail sector as they are more complicated.

The choice of the vehicle is, in principle, dependent on whether an open-end fund or a closed-end fund is desired.

Arrangements and Vehicles for Open-End Funds

For open-end funds, the contractual fund and the investment corporation with variable capital structures are available. They can have different classes of units or shares, and can also establish sub-funds (umbrella structure). For open-end funds, most fund managers prefer a contractual fund to a corporation as the setting up and operation are easier.

Vehicles for Closed-End Funds

For closed-end funds, the only available vehicles for retail funds are the investment corporation with fixed capital and the closed-end investment limited partnership. Managers can only set up a closed-end fund in the form of a contractual fund for non-retail investors.

Both vehicles can issue different classes of shares or interests and establish sub-funds (umbrella structure).

3.1.2 Common Process for Setting Up Investment Funds

The contractual fund is established by the fund manager on a contractual basis with the investor. The contractual fund is a pool of assets separated by statute and contract from the (other) assets of the fund manager. The investment guidelines for contractual funds set out the details of the contractual relationship between the fund manager and the investors, particularly the applicable investment restrictions.

Investment corporations and investment limited partnerships are basically corporations and limited partnerships, with some modifications required by investment law. They are established in accordance with the applicable procedures for establishing corporations and partnerships (with some modifications because of investment law). In addition to the articles of incorporation or the limited partnership agreement (LPA), separate investment guidelines are necessary.

The investment guidelines and marketing of retail funds need BaFin approval. BaFin also has to approve the selection of the depositary for the respective retail fund. The approvals are usually obtained in parallel with each other.

Depending on the type of fund, the process can be rather short in the case of a standardised fund product, or it can be rather lengthy and expensive in the case of a bespoke alternative asset retail fund (in particular, a closed-end fund).

3.1.3 Limited Liability

As further described in **2.1.3 Limited Liability**, investors admitted to investment funds in Germany benefit from limited liability.

3.1.4 Disclosure Requirements

An extensive disclosure document (prospectus) is required if an AIF is marketed to retail investors. The prospectus must contain the following minimum information, where applicable:

- general information on the investment fund;
- the investment policy of the investment fund;
- risks and investor profile;
- the manager, depositary and auditor;
- outsourcing;
- the issue, redemption and conversion of units; and
- past performance.

There are also specific minimum information requirements for the prospectus of closed-end Public AIFs.

In addition to the prospectus, so-called key investor information must also be provided. The key investor information was supplemented by the key information document (KID) in accordance with the European PRIIP (packaged retail and insurance-based investment products) Regulation.

For UCITS, Germany follows the disclosure rules of the UCITS Directive, and, since 2 August 2021, has required that the UCITS prospectus informs the investors about the “facilities” established for local investors under the EU Directive on cross-border distribution of investment funds (Directive (EU) 2019/1160).

As described in **2.1.4 Disclosure Requirements**, there are annual reporting requirements for managers of retail funds and managers of non-retail funds. There are also semi-annual reporting requirements for contractual funds and AG with variable capital. The reports need to be published.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

Retail funds can be subscribed by retail investors as well as by professional and semi-professional investors.

3.2.2 Legal Structures Used by Fund Managers

For open-end funds, the contractual fund and the investment corporation with variable capital structures are available.

For closed-end funds, the only available vehicles for retail funds are the investment corporation with fixed capital and the closed-end investment limited partnership.

For details concerning operational requirements regarding retail funds, see **3.1.1 Fund Structures** and **3.1.2 Common Process for Setting Up Investment Funds**.

3.2.3 Restrictions on Investors

There are only a few restrictions for investors investing in retail funds – eg, German Solvency I investors may not invest in retail open-ended real estate investment funds.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

The main law governing retail funds is the KAGB, which is based on the AIFMD and the UCITS Directive and which is supplemented by German-specific rules for retail funds. In addition, several lower-level ordinances apply (the Derivative Ordinance, the Organisational and

Rules of Conduct Ordinance and the Mediation Ordinance).

This set of laws is supplemented by self-regulatory standards, mainly the Rules of Good Conduct issued by the German Investment Funds Association and the Association's sample investment guidelines.

As described in **2.3.1 Regulatory Regime**, a full fund management licence opens the door for a manager to market funds to retail investors.

3.3.2 Requirements for Non-Local Service Providers

See **2.3.2 Requirements for Non-Local Service Providers**.

3.3.3 Local Regulatory Requirements for Non-Local Managers

The management of a retail AIF is not permitted for non-local managers.

For UCITS, management by non-local UCITS managers is possible via the cross-border passport under the UCITS Directive.

3.3.4 Regulatory Approval Process

The licensing procedure can take from six to 12 months, or sometimes longer.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

The rules concerning pre-marketing only apply to AIFs, as noted in **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**.

3.3.6 Rules Concerning Marketing of Retail Funds

Retail funds can be marketed only by the following three categories of "marketers".

- The fund manager itself can always market its "own" funds and, if fully licensed (ie, not only registered as a sub-threshold manager), may also market investment funds of other managers.
- MiFID firms are entitled to market investment funds (provided they have a MiFID licence or passport for investment advice and the transmission or receipt of orders).
- Firms or individuals with a financial intermediary licence under the German Commerce Act (GewO) may also market retail funds. The financial intermediary licence is a non-MiFID licence and is based on the optional exemption from MiFID II stipulated in Article 3 of MiFID II. However, since 2 August 2021, these firms or individuals may no longer engage in pre-marketing on behalf of a manager.

If the retail fund is marketed by the fund manager itself, the fund manager must make the fund documents and the latest semi-annual and annual fund reports available to the prospective investor. In addition, certain ongoing publication requirements apply (such as the publication of fund documents and fund reports on the manager's website).

For MiFID firms, Germany considers the prospective investor as the regulatory client of the MiFID firm. Accordingly, MiFID firms have to adhere to the MiFID II rules of good conduct towards the prospective investor (requiring items such as suitability or appropriateness checks). This applies in a broadly similar fashion to the above-mentioned GewO firms. The MiFID application further means that marketing materials provided by the fund manager must comply with the MiFID II requirements on marketing materials (eg, with regard to past or simulated performance). As mentioned in **2.3.6 Rules Concerning Marketing of Alternative Funds**, managers have been subject to similar requirements on the content of their marketing materials as MiFID firms.

3.3.7 Marketing of Retail Funds

Retail funds can be marketed to any investor in Germany (regardless of whether the investor is professional, semi-professional or retail).

3.3.8 Marketing Authorisation/Notification Process

The marketing of alternative funds or UCITS to retail investors requires either an authorisation by BaFin or, with respect to UCITS, a European marketing passport under the UCITS Directive.

3.3.9 Post-Marketing Ongoing Requirements

There are annual and semi-annual reporting requirements for managers of retail funds. The reports need to be published. Furthermore, the redemption price must be published as well as any disclosures made in the home country of such manager.

3.3.10 Investor Protection Rules

In addition to that which was previously discussed in **2.3.10 Investor Protection Rules**, civil law prospectus liability rules offer effective protection for retail investors. Basically, civil law prospectus rules impose a liability on the manager and initiator of the fund. The measuring stick is whether the prospectus is incomplete or misleading in aspects that are material for the investment decision of a typical investor.

3.3.11 Approach of the Regulator

As noted in **2.3.11 Approach of the Regulator**, BaFin is generally co-operative and open to discussions.

3.4 Operational Requirements

Germany offers different types of retail funds – eg, UCITS, real estate funds, funds of hedge funds, closed-end funds and infrastructure funds. The fund types are based on the UCITS investment and borrowing restrictions as the default rules. The investment and borrowing restrictions are then modified to fit each fund type.

The KAGB contains a catalogue of assets in which a closed-end Public AIF may invest. The investment in other funds by a closed-end Public AIF is restricted (ie, the structuring of a fund of funds or feeder fund as a retail fund).

For a further overview, see **2.4 Operational Requirements.**

3.5 Fund Finance

The explanations given in **2.5 Fund Finance** (regarding alternative investment funds) also apply to fund finance for retail funds.

3.6 Tax Regime

German tax law does not provide for a specific tax regime applying to funds targeting retail investors. However, for taxation at investor level, different tax rules apply to institutional corporate investors and retail individual investors. The rules for retail individual investors are as follows.

Funds Organised as Partnerships

Domestic funds eligible for non-trading treatment

Resident retail individual investors

A resident retail individual investor's allocable share of interest, dividends, capital gains relating to debt instruments and equity capital gains of shareholdings representing an indirect interest of less than 1% are subject to German income tax at a flat rate of approximately 26.4% (including solidarity surcharge) plus church tax, if applicable. Equity capital gains of shareholdings representing an indirect interest of 1% or more are subject to German income tax levied at the marginal tax rate, but 40% of such capital gains are exempt from income tax.

Non-resident retail individual investors

A non-resident retail individual investor's allocable share of interest (other than profit-linked), dividends from non-German portfolio companies, capital gains relating to debt instruments and equity capital gains aside from shareholdings in German portfolio companies representing an indirect interest of less than 1% are not subject to German income tax.

Equity capital gains of shareholdings in German portfolio companies representing an indirect interest of 1% or more are subject to German income tax at the marginal tax rate, but 40% is exempt from income tax. Tax will be levied by way of assessment, based upon a German tax return to be filed by the non-resident retail individual investor. Such German tax-paying obligation does not apply to non-resident retail individual investors who are entitled to tax treaty benefits.

A non-resident retail individual investor's allocable share of dividends from German portfolio companies is subject to German withholding tax at the rate of approximately 26.4%, and investors who are entitled to tax treaty benefits can file an application with the German federal tax office for a refund of the excess of the German withholding tax over the amount permitted under the applicable tax treaty.

Domestic funds eligible for trading treatment

Resident retail individual investors

Generally, a resident retail individual investor's allocable share of income from a domestic trading fund partnership is subject to its personal income tax rate plus solidarity surcharge thereon. However, 40% of dividends and capital gains of shareholdings are exempt from tax (so-called partial income taxation). While a trading fund partnership is subject to trade tax at its own level (see **2.6 Tax Regime**) there is no additional trade tax at the level of resident retail individual investors. Rather, resident retail individual investors are entitled to a tax credit of their allocable share of the trade tax paid by the partnership. However, this mitigates but does not eliminate the trade tax burden.

Non-resident retail individual investors

In case of a domestic trading fund partnership, the taxation of a non-resident retail individual investor is identical to the taxation of a resident retail investor. Non-resident retail individual investors must file a German tax return. Treaty benefits are not available to non-resident individual investors of a domestic trading fund partnership.

Non-German funds

Resident retail individual investors

As set forth in **2.6 Tax Regime**, non-German funds are typically trading from a German tax perspective. Accordingly, a resident retail individual investor's allocable share of a non-German fund's taxable profits is subject to German income tax as follows: 60% of equity capital gains and dividends, and the full amount of interest is subject to German income tax at the marginal tax rate.

Non-resident retail individual investors

While non-German funds are typically trading from a German tax perspective, they typically do not operate a German permanent establishment to which their income would be attributable. Accordingly, a non-resident retail individual investor's allocable share of the taxable profits of a non-German fund is subject to German tax only on German-source items of income, in accordance with the rules explained above for German funds that are eligible for non-trading treatment.

Corporate-Type Funds

Non-resident retail individual investors

Income derived from German or non-German corporate-type funds (including funds of a contractual type such as the German *Sondervermögen* and non-German fund vehicles that resemble a German *Sondervermögen*) is not subject to tax in Germany.

Resident retail individual investors

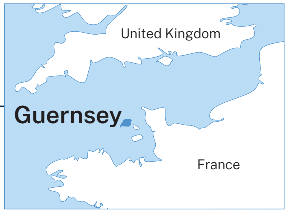
The three items of income described in **2.6 Tax Regime** and derived by them from a German or non-German corporate-type fund are subject to German income tax at a flat rate of approximately 26.4% (including solidarity surcharge) plus church tax, if applicable. The partial tax exemptions for which they may be eligible amount to 30% in respect of equity funds and 15% in respect of mixed funds. Resident retail individual investors are not subject to trade tax.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Germany is constantly implementing any EU directives and modernising its rules, by a number of amendments to the KAGB. Recent changes have already been discussed throughout this chapter, where relevant. Following the revision of AIFMD, the required changes to the KAGB are already in the legislative process and are expected to just mirror the revised AIFMD. In addition, BaFin reviews and updates its administrative pronouncements and FAQs on a regular basis. Before the failure of the coalition in the federal parliament, the German government had launched legislative initiatives that would have affected, inter alia, the tax treatment of investments by certain investment funds in Germany, the opportunities for German pension investors to invest, eg, in infrastructure projects and relief from German taxation of passive foreign investment companies. It remains to be seen to what extent these projects will be taken up again by a new government.

GUERNSEY



Law and Practice

Contributed by:
Matthew Brehaut
Carey Olsen

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Contributed by: Matthew Brehaut, **Carey Olsen**

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Author

Matthew Brehaut is a partner in the Guernsey corporate team at Carey Olsen's London office. He advises on Guernsey corporate and investment funds matters, and provides funds, fund service providers and fund promoters with advice on all aspects of the establishment, regulation and operation of investment funds. Matt trained at Clifford Chance in London and New York, where he specialised in the establishment of institutional closed-ended investment funds. He qualified as an English solicitor in the Private Funds Group in 2004. Matt joined Carey Olsen in May 2016.

Carey Olsen

Carey Olsen LLP
Forum St Paul's
London
EC2V 8AS
UK

Tel: +44 207 614 5620
Fax: +44 207 628 0652
Email: matt.brehaut@careyolsen.com
Web: www.careyolsen.com

CAREY OLSEN

1. Market Overview

1.1 State of the Market

Guernsey is frequently used by advisers and managers globally for the formation/domiciling of investment funds. Guernsey is one of the world's largest offshore finance centres, with a thriving funds industry.

As of 30 June 2024, over 1,340 investment funds and over 1,580 sub-funds were domiciled and/or administered in the island. The most recent aggregate value of funds under management and administration in Guernsey is reported as over USD530 billion, of which USD344 billion is in closed-ended Guernsey funds.

Guernsey attracts all types of fund sponsors/managers – ie, sponsors/managers of:

- private funds;
- hedge funds;
- listed funds; and
- quasi-retail funds (although there is no UCITS equivalent offering in Guernsey).

Additionally, the fund "types" include the full span of asset classes and strategies, such as:

- alternatives (including private equity, debt, infrastructure, real estate, venture capital, growth, tech, etc); and
- open-ended funds (again, with a broad range of asset classes).

Closed-ended alternative/private funds are the most common fund type attracted to Guernsey as a funds domicile, with the remainder being Guernsey open-ended funds and non-Guernsey schemes.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

The principal legal vehicles used to set up alternative investment funds are as follows:

- open-ended – most open-ended funds established in Guernsey are structured as limited companies, protected cell companies or incorporated cell companies;
- closed-ended – most closed-ended funds established in Guernsey are structured as limited partnerships; and
- unit trusts are also used for both open and closed-ended Guernsey funds.

The Advantages and Disadvantages of Using Such Structures

Companies

All types of company:

- offer limited liability to investors;
- are managed by a board of directors;
- are non-tax transparent; and
- (unless they elect otherwise) are deemed Guernsey-resident for Guernsey tax purposes.

A protected cell company provides (by way of statute) for the creation, within the single legal entity of that company, of separate pools of assets segregated from the other assets and liabilities of the company and its other cells, with creditors having recourse limited to the assets of a particular cell.

An incorporated cell company takes this statutory segregation one step further such that each cell is a separately registered legal entity with:

- its own memorandum and articles of incorporation;
- its own company registration number; and
- its own board of directors (though the board composition of each incorporated cell must have one director in common with the board of the core).

In a protected cell company, the cells are not separately registered legal entities, and the protected cell company (as a single legal entity) has a single board of directors, and a memorandum and articles of incorporation.

Limited partnerships

A limited partnership is comprised of:

- one or more general partners who are jointly and severally liable for all debts of the limited partnership without limitation; and
- one or more limited partners who contribute (or agree to contribute) a specified sum to the capital of the limited partnership, and who are not liable for any debts of the limited partnership beyond the amounts contributed (or agreed to be contributed).

The property of the limited partnership is held on trust by the general partners jointly as assets of the limited partnership in accordance with the terms of the limited partnership agreement. Limited partnerships are tax-transparent for Guernsey tax purposes.

Unit trusts

A unit trust is not a separate legal entity but is a fiduciary relationship between a trustee and one or more beneficiaries in relation to particular assets. This relationship is constituted by an agreement in writing, commonly known as a "trust instrument". In the context of a fund established as a unit trust, the trust instrument contains (in addition to elements/provisions relating to the relevant trust law) contractual provisions that will exist between a manager (appointed by the trustee to manage the assets) and the trustee.

The assets of a unit trust are held by its trustee on trust for the benefit of the beneficiaries (the unit-holders (investors)) and are managed by the manager, who may appoint one or more investment managers or advisers to assist it. Contracts in relation to the management and administration of the trust will be entered into by the manager; whereas the trustee will enter into contracts in relation to the assets themselves, such as bank deposits, borrowings and security agreements.

The participants' interests in the above vehicles are referred to accordingly:

- for companies – shares;
- for limited partnerships – limited partnership interests; and
- for unit trusts – units.

Guernsey investment managers and/or investment advisers of alternative investment funds are principally established as companies or limited liability partnerships.

2.1.2 Common Process for Setting Up Investment Funds

Every "collective investment scheme" ("fund") domiciled in Guernsey will be subject to the provisions of Guernsey's principal funds legislation (the Protection of Investors (Bailiwick of Guernsey) Law, 2020, as amended (the "POI Law")) and be regulated by Guernsey's regulatory body for the finance sector (the Guernsey Financial Services Commission (GFSC)). The POI Law splits Guernsey funds into two categories:

- "registered funds", which are registered with the GFSC; and
- "authorised funds", which are authorised by the GFSC.

Essentially, the difference between authorised funds and registered funds is that authorised funds receive their *authorisation* following a substantive review of their suitability by the GFSC, whereas registered funds follow a "fast track" regime whereby they receive their *registration* following a representation of suitability from a Guernsey body holding a POI Law licence. Such body would be the administrator, which scrutinises the fund and its promoter in lieu of the GFSC, and which takes on the ongoing responsibility for monitoring the fund – effectively a form of "self-certification" by a Guernsey licensed administrator. One exception to this is authorised funds which opt into the "qualifying investor fund" regime – these also benefit from the "fast track" regime (although only "qualified investors" may invest into a "qualifying investor fund").

The rules governing the different classes of Guernsey funds also distinguish between whether they are open-ended or closed-ended (or can choose from either). A Guernsey fund is open-ended if the investors are entitled to have their units redeemed or repurchased by the fund at a price related to the value of the property to which they relate (ie, the NAV).

The POI Law grants the GFSC the ability to develop different classes of authorised and registered funds, and to determine the rules applicable to such classes. The following types of authorised and registered funds are currently available.

Authorised Funds

Authorised fund types are as follows.

- Class A: retail funds offering. Class A funds have largely been superseded by the AIFMD regime. These are open-ended only.
- Class B: these can be structured as retail products marketed to the public, or established as strictly private or institutional funds. They are open-ended only.
- Class Q: these are not retail funds as they can only be beneficially owned by qualifying professional investors (essentially, government bodies or high net worth individuals or entities, with a minimum investment of USD100,000). They are open-ended only.
- ACIS: authorised closed-ended investment schemes. These are closed-ended funds which are subject to the GFSC's permanent and continuing supervision.

Registered Funds

Registered fund types are as follows.

- RCIS funds: registered closed-ended investment schemes, commonly referred to as "registered funds" (as they were the only type of registered fund until the introduction of private investment funds). RCIS funds may be open- or closed-ended.
- Private investment funds (PIFs): intended for funds with a small number of investors. They are not suitable to be used as retail funds.

Originally introduced in 2016, there are now three types of PIFs, as follows.

Route 1

The "POI Licensed Manager" PIF is suited to fund managers that have a closer relationship with their investors. Its distinguishing features include:

- no requirement for minimum investment;
- no requirement for a prospectus;
- a maximum of 50 legal or natural persons holding an economic interest (with no more than 30 admitted in a 12-month period); and
- no limit imposed on the number of potential investors to which the fund can be marketed.

Route 2

A "Qualifying Private Investor" PIF is available to investors who can evaluate the risks and strategy of investing in a PIF and bear the consequences of investment, including the possibility of any loss arising from the investment. The relevant rules define a "Qualifying Professional Investor" as a "professional investor", "experienced investor" and "knowledgeable employee" (the criteria for each of which are specified in the rules).

Qualifying Private Investor PIFs are also subject to a maximum of 50 legal or natural persons holding an economic interest in the fund. Marketing can take place to a maximum of 200 people. Investors must be provided with a disclosure statement that states all material information (including risk disclosures) that an investor would reasonably require to make an informed judgement about the merits and risks of investing in the PIF, as well as certain prescribed disclosures. The administrator must make a declaration to the GFSC that effective procedures are in place to restrict the fund to Qualifying Professional Investors. The administrator should also receive written acknowledgement of receipt of the above-mentioned disclosure statement from investors.

Route 3

A "Family Relationship" PIF is available to investors who share a family relationship (or are an employee of the family). The Family Relationship PIF cannot be marketed outside the family (and employee) group. The administrator must make a declaration to the GFSC that effective procedures are in place to ensure that all investors fulfil the requirement of being related as a family (or employee).

Qualifying Investor Funds (QIFs)

An authorised fund may apply to the GFSC to be approved as a QIF, following which the GFSC's QIF Guidance will apply to it in addition to the authorised rules to which it is already subject. QIFs may only admit investors which are:

- "professional investors"
- "experienced investors"; or
- "knowledgeable employees".

The QIF must have a promoter (ie, the party ultimately responsible for the fund's success) that is fit and proper. There must be effective procedures in place to ensure that only qualifying investors are admitted, and the economic rationale for the fund and any attendant risks must be clearly disclosed. QIFs may be open- or closed-ended.

The GFSC's standard application procedure for authorised funds (ie, Class A funds, Class B funds, Class Q funds and ACIS funds) that do not elect to be approved as QIFs is a three-stage process:

- stage one – outline authorisation;
- stage two – interim authorisation; and
- stage three – formal authorisation once all issues have been resolved and final documentation has been received.

Core documents are as follows:

- constitutional documents of the fund vehicle;

- information particulars/offering memorandum;
- application form/subscription agreement; and
- material contracts – eg, investment management agreement, administration agreement, custody agreement (as applicable).

The GFSC provides the following indicative timeframes:

- outline authorisation within 28 days business days;
- interim authorisation within ten business days; and
- formal authorisation within seven business days.

The GFSC offers fast-track applications in respect of:

- RCIS funds and authorised funds which elect to be approved as QIFs (three business days);
- licences under the POI Law (a "POI licence"), where the manager of RCIS funds and QIFs applies for its licence under the POI Law simultaneously with the funds' application (ten business days, which runs concurrently with the relevant fund application); and
- PIFs, including the manager's licence (one business day).

Core documents for registered funds are as follows.

For RCIS funds:

- constitutional documents of the fund vehicle;
- information particulars/offering memorandum;
- subscription agreement; and
- material contracts – eg, investment management agreement, administration agreement.

For PIFs:

- constitutional documents of the fund vehicle;
- subscription agreement; and
- material contracts – eg, investment management agreement, administration agreement.

Note that PIFs are not required to produce information particulars/offering memorandums (although a Route 2 PIF must produce a disclosure statement).

2.1.3 Limited Liability

Investor limited liability is provided by the fund vehicle. The most-used fund vehicles – limited companies, limited partnerships and unit trusts – all offer limited liability to investors. In general terms, the limits or restrictions on benefiting from limited liability are typically related to whether or not investors participate in the "management" of the fund – eg, a limited partner in a fund that is a limited partnership may lose their limited liability status if they participate in the management of the limited partnership.

Guernsey's limited partnership law provides for specific safe harbours permitting limited partner involvement in decisions without jeopardising their limited liability status.

2.1.4 Disclosure Requirements

An offering document (made up of one or more documents, which may include the core documents of the fund – see **2.1.2 Common Process for Setting Up Investment Funds**), containing the requisite disclosures, must be produced for all types of authorised funds and for registered funds other than PIFs. In each case, the specific disclosure requirements for each fund type must be met.

For a Class A fund, the fund's prospectus must state/contain:

- a description of the fund;
- its investment objective and policy;
- reporting, distributions and accounting dates;
- characteristics of the units;
- particulars of the manager;
- particulars of the directors where the fund is a company;
- particulars of the trustee;
- particulars of any investment adviser;
- the name of the auditor;
- material contract summaries;
- details of the name and address of the registrar;
- details of payments to be made out of fund property;
- disclosure of any decision to treat income expense payments as a capital expense;
- an estimate of the expenses to be incurred by a company fund in respect of its movable and immovable property;
- details of the valuation policy and procedures;
- details of the dealing policy and procedures;
- for a single-priced fund, disclosures in respect of dilution;
- the manager's normal basis of pricing (forward and historic);
- details of any preliminary charge;
- details of any redemption charge;
- information on the umbrella fund, if relevant;
- application of the prospectus contents to an umbrella fund;
- details of any marketing arrangements into the EEA; and
- any other material information reasonably required by an investor to make an informed investment decision.

For a Class B fund, the fund's information particulars must state/contain:

- the name and structure of the fund;
- the names and addresses of key service providers to the fund;
- the investment objectives and restrictions;
- the hedging powers and restrictions (or an appropriate negative statement);
- the borrowing powers and restrictions (or an appropriate negative statement);
- certain accounting and reporting matters;
- the issue and redemption procedure;
- the valuation procedure;
- holders' rights;
- the distribution policy;
- directors' and other material interests;
- fees and expenses;
- sufficient risk warnings;
- the fund's tax status and tax treatments in jurisdictions where it will be marketed; and
- any other material information reasonably required by an investor to make an informed investment decision.

For a Class Q fund, the fund's offering documents must state:

- the name and status of the fund as a Class Q fund;
- the names and addresses of key service providers to the fund;
- a definition of qualifying professional investors and a statement that only qualifying professional investors are eligible to invest;
- the constitution and objectives of the fund;
- the characteristics of units in the fund;
- disclosures in respect of the valuation of the property, charges and distributions;
- the sale and redemption procedure;
- when annual accounts will be published;
- sufficient risk warnings; and
- any other material information reasonably required by an investor to make an informed investment decision.

For an ACIS fund, the fund's information particulars must state/contain:

- the name and structure of the fund;
- the names and addresses of key service providers to the fund;
- the investment objectives and policy;
- the duration of the fund;
- details of the accounting and reporting policies and procedures;
- the subscription procedures;
- the valuation procedures (if any);
- shareholders' rights;
- the distribution policy;
- details of the fees and expenses;
- the fund's tax status and tax treatments in jurisdictions where it will be marketed; and
- any other material information reasonably required by an investor to make an informed investment decision.

For an RCIS fund, the fund's information particulars must state/contain:

- details relating to the offer;
- particulars of the share capital, etc;
- a statement of the value of any goodwill and preliminary expenses;
- a material contract summary;
- directors' and other material interests;
- any options and prior interests;
- details of all borrowings and borrowing powers;
- details of the accounting and reporting policies and procedures;
- registered office details;
- principal establishments;
- details of the designated administrator and custodian (if any);
- details of the directors and secretary of the fund company, corporate general partner or corporate trustee;
- details of the general partner or trustee (if any);
- details of the auditor, legal advisers and principal bankers;
- details of significant beneficial ownership;
- voting and other rights; and
- any other material information reasonably required by an investor to make an informed investment decision.

For a Qualifying Private Investor PIF, the fund's disclosure statement should state all material information (including risk disclosures) that an investor would reasonably require to enable such investor to make an informed judgement about the merits and risks of investing in the PIF.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Institutional investors represent the largest single category of investors in Guernsey-domiciled funds, although sovereign wealth funds, high net worth individuals and family offices are also very active in Guernsey's investment funds market.

2.2.2 Legal Structures Used by Fund Managers

Guernsey investment managers and/or investment advisers of alternative investment funds are principally established as companies or limited liability partnerships.

2.2.3 Restrictions on Investors

Restrictions on ownership of fund interests only apply in relation to funds regulated under the following regulatory regimes in Guernsey.

Class Q Funds

Admission is limited to qualifying professional investors, defined as:

- governments, local authorities or public authorities (in the Bailiwick or elsewhere);
- trustees of trusts which, at the time of investment, have net assets in excess of GBP2 million (or currency equivalent);
- a body corporate or limited partnership, if it or any holding company or subsidiary of it has, at the time of investment, net assets in excess of GBP2 million (or currency equivalent); or
- an individual who has, together with any spouse, at the time of investment, a minimum net worth (which excludes that individual's main residence and household goods) of GBP500,000 (or currency equivalent).

QIFs

Admission is limited to qualifying investors, which are defined as professional investors, experienced investors and knowledgeable employees.

A professional investor is:

- a government, local authority, public authority or supra-national body (in the Bailiwick or elsewhere);
- a person, partnership or other unincorporated association or body corporate, (whether incorporated, listed or regulated in an OECD country or otherwise) whose ordinary business or professional activity includes, or it is reasonable to expect that it includes, acquiring, underwriting, managing, holding or disposing of investments whether as principal or agent, or the giving of advice on investments;
- an affiliate of the QIF or an associate of an affiliate of the QIF (the terms "affiliate" and "associate of an affiliate" are intended to refer to financial services businesses or financial services professionals associated, directly or indirectly, with the operation of the fund in question); or
- an individual investor who makes an initial investment of not less than USD100,000 or equivalent in the fund in question – provided the initial test has been met, subsequent investments by the same investor may be of lower amounts.

An experienced investor is a person, partnership or other unincorporated association or body corporate which has in any period of 12 months (whether on their own behalf or in the course of their employment by another person) frequently entered into transactions of a particular type in connection with:

- open-ended and closed-ended collective investment schemes; and/or
- general securities and derivatives as defined in Schedule 1 of the POI Law (in summary, that definition includes equities, bonds, warrants, options, futures, contracts for differences and rights on any of those investments).

This means transactions of substantial size entered into with, or through the agency of, reputable persons who carry on investment business, where they can reasonably be expected to understand the nature of, and the risks involved in, transactions of that description. Alternatively, it means persons who provide a certificate from an appropriately qualified investment adviser confirming that the investor has obtained independent advice.

A knowledgeable employee is:

- a person who is (or has been within a period of three years up to the date of application for investment in the QIF) an employee, director, general partner, consultant or shareholder of, or to, an affiliate appointed by the QIF to advise, manage or administer the investment activities of the QIF, and who is acquiring an investment in the QIF as part of their remuneration or an incentive arrangement or by way of co-investment, either directly or indirectly, through a personal investment vehicle (such as a trust) for or substantially for that person; or

- any employee, director, partner or consultant to or of any person referred to above, or anyone who has fulfilled such a role in respect of any person referred to above, within a period of three years up to the date of application for investment in the QIF (the term "employee" only covers persons who are, or have been, employed in a relevant role and would not extend to clerical, secretarial or administrative roles).

Route 1 PIFs

Admission is limited to investors able to sustain any losses incurred on their investment at the time they make their investment.

Route 2 PIFs

Admission is limited to "qualifying private investors", which are defined as professional investors, experienced investors and knowledgeable employees. The definitions of these categories of investors are essentially the same as for QIFs, as set out above.

Route 3 PIFs

Admission is limited to investors sharing a family relationship, or who are eligible employees of the family (such employees must also meet the definition of a "qualifying private investor").

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Investment business in Guernsey is regulated by the GFSC. The principal legislation governing the conduct of investment business (including funds and associated entities) is the POI Law. Each type of collective investment scheme is subject to particular rules issued by the GFSC – for example, in respect of RCIS funds, the Registered Collective Investment Scheme Rules and Guidance, 2020.

Only Class A funds, which have been largely superseded by the AIFMD regime, are subject to regulatory limitations on their investments.

2.3.2 Requirements for Non-Local Service Providers

The requirement to have a Guernsey-based manager applies only to Route 1 PIFs, as described below). However, as indicated in **1.1 State of the Market**, the most common fund type is the closed-ended private fund, which is generally structured as a limited partnership or corporate. Consequently, in the context of the limited partnership structure, the Guernsey-based general partner of these funds is usually the "manager" of the fund, which is then advised by a non-Guernsey adviser (generally UK-based). In the corporate structure, the manager is usually non-Guernsey-based (again, generally UK- or US-based).

All Guernsey funds must appoint a local designated administrator, which must be licensed by the GFSC. The designated administrator conducts the day-to-day administration of the fund and has certain oversight responsibilities to ensure that the fund is operated in accordance with its constitutional and offering documents and with Guernsey law and regulation.

All open-ended funds must appoint a Guernsey custodian, licensed by the GFSC. Institutional or expert investor hedge funds can be permitted to appoint a foreign prime broker rather than a local custodian or trustee, which is not required to offer physical segregation of fund assets from its own, so long as the fund prospectus makes clear the risks of such arrangement. Retail or less-sophisticated investor hedge funds can be permitted to appoint a foreign prime broker to take control of the fund's property, but will normally be expected to appoint a local custodian or trustee to oversee the prime broker.

All Route 1 PIFs must appoint a Guernsey-based manager, licensed by the GFSC, which is responsible for making certain representations and warranties to the GFSC on the ability of investors to suffer losses.

As expected from a jurisdiction with over GBP500 billion of funds under management and administration, Guernsey has a wealth of first-class fund service providers, including administrators, lawyers, auditors and custodians. This creates a virtuous circle – as funds under management increase, so does the depth of expertise, which in turn attracts further funds under management.

Guernsey also benefits from a large number of highly experienced, independent non-executive directors providing additional investment management experience, as well as guidance and oversight for funds, and ensuring that the highest standards of corporate governance are observed.

2.3.3 Local Regulatory Requirements for Non-Local Managers

As is the case with regulators of most other jurisdictions, the GFSC has direct authority only over those entities which it has licensed or authorised, and which conduct business in or from within Guernsey; and those entities are answerable to the GFSC.

The POI Law makes it a criminal offence, subject to certain exceptions, for any person to carry on or hold themself out as carrying on any "controlled investment business" in or from within Guernsey without a POI licence issued by the GFSC. Additionally, it is an offence for a Guernsey body to carry on or hold itself out as carrying on any controlled investment business in or from within a territory outside Guernsey, unless that body is licensed to carry on that business in Guernsey and the business would be lawfully carried on if it were carried on in Guernsey.

As such, in terms of services (eg, investment management or advisory) being provided by non-Guernsey entities from outside Guernsey, the GFSC does not have direct authority over those providers, whose authority rightly sits with the regulator in their home jurisdiction. However, in regulating the relevant fund the GFSC will consider (as one of the elements in authorising or registering the fund and on an ongoing basis) the quality of the non-service providers. The home jurisdiction, home regulatory body and the size and reputation of the provider are all considered by the GFSC. Funds domiciled in Guernsey are, therefore, free to contract the services of any provider in another jurisdiction, subject always to both a determination by the relevant fund of the "fit and properness" of the service provider and to the oversight of the GFSC over the relevant fund.

2.3.4 Regulatory Approval Process

The time required to obtain regulatory approval depends on the type of fund registration/authorisation being sought. More detail is provided in respect of each fund type in **2.1.2 Common Process for Setting Up Investment Funds**.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

There is no legal definition of pre-marketing. However, by convention the GFSC makes a distinction between pre-marketing activities and marketing activities in determining whether the restricted activity of "promotion" is being undertaken by a person.

Pre-marketing activities (such as the circulation of "red herring" documentation) are generally permitted without the need for the person undertaking those activities to obtain a licence or rely on an exemption under the POI Law, provided it is made clear that:

- no offer is being made to investors to subscribe for shares in the collective investment scheme; or
- no invitation is being made to apply to participate in the collective investment scheme by any person.

The authors note, however, that this is not a matter of law but of regulatory practice, so advice should be taken on the specific facts.

2.3.6 Rules Concerning Marketing of Alternative Funds

Pursuant to the POI Law, the promotion of collective investment schemes is a restricted activity and requires a POI licence if carried on in or from within the Bailiwick, unless one of the statutory exemptions applies.

If certain conditions are met, including registration with the GFSC, the following may be promoted in the Bailiwick by an overseas promoter to the public without a POI licence:

- EEA AIFs;
- certain UK unit trusts;
- certain Jersey collective investment schemes; and
- certain Isle of Man and Republic of Ireland authorised schemes.

Similarly, if certain conditions are met, including notification to the GFSC, a wider range of funds can be promoted, provided such promotion is restricted to entities licensed by the GFSC.

In addition, neither a POI licence nor a notification to the GFSC would be required by an overseas promoter if the marketing were carried out on a non-solicitation basis. The GFSC would not normally consider marketing campaigns by an overseas promoter that do not originate from within the Bailiwick and that do not specifically target Bailiwick residents (but might include the Bailiwick as part of a wider population) as constituting a restricted activity or requiring a POI licence.

2.3.7 Marketing of Alternative Funds

Subject to the regulatory requirements summarised in **2.3.6 Rules Concerning Marketing of Alternative Funds** and **2.3.8 Marketing Authorisation/Notification Process**, and the restrictions specific to certain types of funds summarised in **2.1.2 Common Process for Setting Up Investment Funds**, there are no restrictions on the types of the investors in Guernsey to whom alternative funds may be marketed.

2.3.8 Marketing Authorisation/Notification Process

Authorisation or notification is required by the GFSC prior to the marketing of alternative funds, if not relying on reverse solicitation.

Promotion to the public of certain categories of funds as mentioned in **2.3.6 Rules Concerning Marketing of Alternative Funds** requires a GFSC notification (to which the GFSC must issue a confirmation), and the promoter must be able to satisfy the following:

- that it carries on that activity (ie, the promotion of the funds) in or from within the Bailiwick, in a manner in which it is permitted to carry on such activity in or from within, and under the law of, a designated country or territory which, in the opinion of the Committee for Economic Development, affords (in relation to activities of that description) adequate protection to investors;
- that it has its main place of business in that country or territory and does not carry on any restricted activity from a permanent place of business in the Bailiwick; and
- that it is recognised as a national of that country or territory by its law.

Promotion to entities licensed by the GFSC by a firm with a main place of business in one of the countries or territories designated for the purposes of Section 44(1)(d) of the POI Law (which includes the UK) does not require a licence, provided that a GFSC notification is made and that the promoter is able to satisfy the following.

- The firm does not have a permanent place of business within the Bailiwick.
- The firm is an entity established in a country or territory designated and listed in the first column of the Schedule to the Investor Protection (Designated Countries and Territories) (Bailiwick of Guernsey) Regulations, 2017. This list is extensive and includes signatory countries to the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, established by the International Organisation of Securities Commissions in May 2002 – the authors note that the UK is included.
- The promotion is carried out in accordance with the laws of that designated country or territory.

2.3.9 Post-Marketing Ongoing Requirements

Firms making use of marketing to the public regime must pay an annual fee (following an initial fee). Otherwise, there are no ongoing requirements, provided the circumstances do not change.

2.3.10 Investor Protection Rules

Regarding investor protection provisions, see 2.2.3 Restrictions on Investors.

Regulatory reporting requirements depend on the relevant fund type and may be summarised as follows.

- For Class A funds, Class B funds and Class Q funds, the manager must provide to the GFSC:
  (a) reports issued to investors; and
  (b) either an annual notification of any changes to the information contained in the application form, or a confirmation that there are no changes.
- For RCIS funds and PIFs, the manager must provide to the GFSC:
  (a) either an annual notification of any changes to the information contained in the application form, or a confirmation that there are no changes;
  (b) an audited annual report and accounts within six months of the year-end; and
  (c) a quarterly statistical return.
- Audited financial statements must be submitted annually to the GFSC.

- Statistical returns must be filed quarterly with the GFSC.
- Proposals for material changes to Guernsey funds must be notified to the GFSC.
- Companies, limited partnerships and partnerships are subject to annual return filing requirements with the Registrar of Companies.
- Annual tax filings must be made by all companies.

Of the above, only the Guernsey Registry annual return is publicly available.

2.3.11 Approach of the Regulator

Guernsey maintains a robust, proportionate, flexible and competitive funds regulatory regime, adopting a risk-based approach to ensure that appropriate levels of investor protection are maintained, while at the same time avoiding unnecessarily complex, prescriptive or burdensome regulation (or granting waivers of certain regulatory requirements where considered appropriate).

The attitude of the regulator continues to be one of fostering constructive approachability. This is built firmly on the basis of a transparent, open and co-operative approach. The GFSC's view has always been to understand at an early stage where there are potential issues, and to identify, with the relevant section of industry, solutions to those issues that will ultimately produce the best outcome for all stakeholders and thereby protect the reputation of Guernsey. As such, the regulator is always open to discussions on regulatory questions, opens issues to consultation and publishes guidance on regulatory matters where such guidance would be helpful to practitioners or the industry as a whole.

The GFSC works closely with the funds industry to ensure that the regulatory regime continues to evolve and provide the kinds of structures required by today's investors, with the protection of those investors (commensurate with their sophistication) at the forefront. There is ongoing engagement between the GFSC and industry experts to further the island's interests.

This engagement has given Guernsey a strong track record in innovation, having created the protected cell company over 25 years ago (a concept which has been copied globally). More recently, the PIF regime was launched (and subsequently expanded in scope), providing fund classes specifically designed to reflect the often close relationship between fund managers and their investors, and to facilitate smaller funds with sophisticated investors.

The close relationship between the GFSC and Guernsey's funds industry also ensures a high level of pragmatism and responsiveness. Fund vehicles can be established on a same-day basis and regulatory approval times can be as little as one day. By and large, the GFSC adheres to stated timeframes.

The regulator approaches enforcement on a proportionality basis. This means that "enforcement" spans a range of actions from remediation of breaches to sanctions and criminal proceedings.

2.4 Operational Requirements

Restrictions on types of activity or types of investment, and asset-protection requirements, depend on the relevant fund type and are summarised in **2.2.1 Types of Investors in Alternative Funds**.

2.5 Fund Finance

Subject to certain restrictions in respect of Class A funds (see below), Guernsey alternative funds may access fund finance for subscription financing and/or leveraging, provided the appropriate borrowing powers and limits are set out in the fund's offering documents and constitutional documents.

A Class A fund may borrow up to 10% of the value of the fund's property on a temporary basis, subject to any restriction in its constitutional or offering documents, from an eligible institution or an approved bank. Any period of borrowing that exceeds three months must be approved by the fund's trustee/custodian.

Other than the above, there are no statutory or regulatory limits in relation to borrowing, and any such limitations would be a matter for the powers/constitution of the relevant fund.

Finance has traditionally been obtained from banks and/or banking institutions. However, borrowing by Guernsey funds is influenced by the trends in the finance market as a whole; as such, Guernsey-domiciled funds have access to finance from banks and other alternative institutional or personal lenders, including other funds and specialist debt providers, domiciled both in Guernsey and elsewhere.

No common issues are experienced in relation to fund finance.

2.6 Tax Regime

If the fund is structured as a company, it will be subject to income tax at 0% unless it obtains tax-exempt status (where no tax will be applicable) for an annual fee of (currently) GBP1,600. Funds structured as limited partnerships or unit trusts are not themselves subject to Guernsey tax (they are "tax transparent" as they have no separate legal personality).

Distributions made by a Guernsey fund to Guernsey-resident shareholders may be taxed on the shareholder at the standard income tax rate of 20% for individuals and 0% for corporations, irrespective of whether the corporation is itself taxable in Guernsey on sources of income at a rate other than 0%. Distributions made by a fund to non-Guernsey-resident investors, whether made during the life of the fund or by distribution on liquidation, will not be subject to Guernsey tax, provided such payments are not taken into account in computing the profits of any permanent establishment situated in Guernsey through which such investor carries on a business in Guernsey.

A Guernsey fund that is structured as a company, and that has not obtained tax-exempt status at the time a distribution is made, would be required to withhold tax at the applicable rate in respect of any distributions made (or deemed to have been made) to shareholders who are Guernsey-resident individuals. Under Guernsey tax law, no withholding of tax should be required in respect of distributions to Guernsey-resident unit-holders of Guernsey funds which are not structured as companies or if, at the time a distribution is made, the Guernsey fund structured as a company has tax-exempt status.

There is no stamp duty or equivalent tax payable in Guernsey on the issuance, transfer or redemption of units in Guernsey funds. Guernsey charges no document duty on the creation or increase of authorised share capital.

The States of Guernsey has passed enabling legislation for the introduction of a system of goods and services tax (GST); however, no decision as to the introduction of GST has been made.

Under current Guernsey tax law, there is no liability to capital gains tax, wealth tax, capital transfer tax or estate or inheritance tax on the issuance, transfer or realisation of units in Guernsey funds (save for registration fees and ad valorem duty for a Guernsey grant of representation when the deceased dies leaving assets in Guernsey which required presentation of such a grant).

Guernsey has a wide-ranging anti-avoidance provision. This provision targets transactions where the effect of the transaction or series of transactions is the avoidance, reduction or deferral of a tax liability. At their discretion, the Director of the Revenue Service will make such adjustments to the tax liability to counteract the effect of the avoidance, reduction or deferral of the tax liability.

Guernsey is committed to adopting the base erosion and profit shifting (BEPS) minimum standards. Guernsey implemented country-by-country reporting in respect of accounting periods commencing on or after 1 January 2016, and has also adopted the spontaneous exchange of tax rulings with other jurisdictions. On 7 June 2017, Guernsey, along with over 60 other jurisdictions, signed the OECD's Multilateral Instrument to Implement Tax Treaty-Related Measures to Combat BEPS and Treaty Abuse.

Like other offshore jurisdictions, Guernsey implemented legislative economic substance requirements, effective from 1 January 2019, to address concerns raised by the EU's Code of Conduct Group on Business Taxation that Guernsey's corporate tax system could facilitate offshore structures aimed at attracting profits which do not reflect real economic substance. Guernsey tax-resident companies and limited partnerships registered in Guernsey will be subject to substance requirements where and to the extent that they carry on a relevant activity. For the funds industry, the most relevant of the above activities will be:

- fund management;
- financing;
- headquartering; and
- distribution and service centres.

However, collective investment schemes (other than self-managed collective investment schemes) are not within the scope of substance requirements, and nor are trusts (although a corporate trustee may be).

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Guernsey does not specifically offer retail funds other than Class A funds, which have largely been superseded by the AIFMD regime. Otherwise, all fund types are open to retail investors, subject to the relevant rules specific to each fund type (other than Class Q funds, QIFs and PIFs, which would not be suitable for retail investors).

Subject to those considerations, the previously discussed responses regarding alternative investment funds apply equally to retail funds.

3.1.2 Common Process for Setting Up Investment Funds

See **2.1.2 Common Process for Setting Up Investment Funds.**

3.1.3 Limited Liability

See **2.1.3 Limited Liability**.

3.1.4 Disclosure Requirements

See **2.1.4 Disclosure Requirements**.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

See **2.2.1 Types of Investors in Alternative Funds**.

3.2.2 Legal Structures Used by Fund Managers

See **2.2.2 Legal Structures Used by Fund Managers**.

3.2.3 Restrictions on Investors

See **2.2.3 Restrictions on Investors**.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

See **2.3.1 Regulatory Regime**.

3.3.2 Requirements for Non-Local Service Providers

See **2.3.2 Requirements for Non-Local Service Providers**.

3.3.3 Local Regulatory Requirements for Non-Local Managers

See **2.3.3 Local Regulatory Requirements for Non-Local Managers**.

3.3.4 Regulatory Approval Process

See **2.3.4 Regulatory Approval Process**.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

See **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**.

3.3.6 Rules Concerning Marketing of Retail Funds

See **2.3.6 Rules Concerning Marketing of Alternative Funds**.

3.3.7 Marketing of Retail Funds

See **2.3.7 Marketing of Alternative Funds**.

3.3.8 Marketing Authorisation/Notification Process

See **2.3.8 Marketing Authorisation/Notification Process**.

3.3.9 Post-Marketing Ongoing Requirements

See **2.3.9 Post-Marketing Ongoing Requirements**.

3.3.10 Investor Protection Rules

See **2.3.10 Investor Protection Rules**.

3.3.11 Approach of the Regulator

See **2.3.11 Approach of the Regulator**.

3.4 Operational Requirements

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INDIA

Pakistan
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Law and Practice

Contributed by:
Tejesh Chitlangi, Sushreet Pattanayak, Pooja Mehta and Anita Jain
IC Universal Legal

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IC Universal Legal is considered India's top law firm in the financial services legal-regulatory space, including investment funds. The firm has eight offices and 200 lawyers across the country, and provides end-to-end solutions for the full life cycle of funds, from set-up to obtaining regulatory licences to limited partnership negotiations to deployment in investee companies. IC Universal Legal represents some of the India's largest private equity funds, such as Kedaara, TVS Capital, Xponentia and True North, as well as some of the world's largest India-centric foreign Venture Capital Funds, such as Matrix, Peak XV (formerly Sequoia India) and Lightspeed. The firm has been ranked as a Band 1 Firm in Investment Funds by Chambers and Partners.

Authors

Tejesh Chitlangi is joint managing partner of IC Universal Legal. He is one of the most quoted securities lawyers in India, and is considered an authority in the Indian financial services legal regulatory space. Tejesh is a member of several regulatory working groups and committees, including the prestigious SEBI Alternative Investment Policy Advisory Committee (AIPAC) and the first Expert Committee on Investment Funds set up by the International Financial Services Centres Authority (IFSCA). He is a regular speaker at global events. Tejesh has consistently been ranked a Band 1 lawyer in Investment Funds by Chambers and Partners.

Sushreet Pattanayak is an accomplished corporate lawyer at IC Universal Legal with a strong focus on investment funds and asset management. Having worked with both established institutional clients and first-time wealth managers, he has over a decade of experience advising clients on a diverse range of subjects. These include fund formations for both India-focused and global funds across diverse asset classes, LP onboarding and negotiations, asset management company buyouts, inbound and outbound investment structures, securities laws, and on day-to-day legal and regulatory matters.

Pooja Mehta advises leading domestic fund managers, asset management companies and first-time fund managers for IC Universal Legal on the formation, registration, and documentation of alternative investment funds, including private equity, hedge, venture capital, real estate funds and debt funds. She has played a pivotal role in representing fund managers in various LP-GP negotiations against global DFIs, family offices and domestic institutions. Pooja also has significant experience structuring India-focused offshore funds, including setting up funds in GIFT City. She regularly liaises with the SEBI and IFSCA as part of their various policy initiatives on investment funds.

Anita Jain has extensive expertise in advising on investment funds, including the formation of funds in debt and credit, real estate, and private equity, alongside the legal and commercial aspects of their operation. She specialises in co-investment arrangements in both domestic and GIFT City markets. Anita offers strategic counsel to investment managers on managing private funds and asset management structures, and in fund-raising negotiations with a balanced approach. Her expertise spans financial services, securities laws, and strategies for inbound and outbound investments. She advises some of India's leading Asset Management Companies on legal, regulatory, investment, and governance matters.

IC Universal Legal

IC Universal Legal
209, Hubtown Solaris
Prof NS Phadke Marg
Andheri East
400069 Mumbai
India

Tel: +91 (22) 6184 9901
Email: tejesh.chitlangi@icul.in
Web: www.icul.in

IC
UL
IC UNIVERSAL
LEGAL
Advocates & Solicitors

Contributed by: Tejesh Chitlangi, Sushreet Pattanayak, Pooja Mehta and Anita Jain, **IC Universal Legal**

1. Market Overview

1.1 State of the Market

India offers the following frameworks for domestic and overseas fund managers looking to set up alternative investment funds.

- Domestic investment funds regulated by the Securities and Exchange Board of India (SEBI), including privately placed alternative investment funds (Domestic AIFs) governed by the SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations") and retail mutual funds governed by the SEBI (Mutual Funds) Regulations, 1996 ("MF Regulations"). Under the AIF Regulations, Domestic AIFs generally take the form of trusts and must have a manager and a sponsor, with both regulated by the SEBI.
- Investment funds (GIFT Funds) set up at International Financial Services Centre (IFSC) Gujarat International Finance Tec-City (GIFT or GIFT City). The International Financial Services Centres Authority (IFSCA) is the GIFT City regulator, and GIFT Funds are governed by the International Financial Services Centres Authority (Fund Management) Regulations, 2022 ("FM Regulations"). At GIFT, the IFSCA regulates the Fund Management Entity (FME), which may launch schemes in accordance with the FM Regulations.

Fund managers intending to set up India-focused funds would need to determine whether a Domestic AIF or a GIFT Fund would be the best choice based on criteria such as the investors involved and the fund's investment strategy. GIFT Funds are treated as non-resident for the purposes of India's foreign exchange laws, so any exposure of GIFT Funds to India would be via available foreign investment route – eg, Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI). If the fund expects to pool monies from resident Indians to primarily make Indian investments, a Domestic AIF would be the proposed structure. India-focused funds expecting participation from both overseas and domestic investors might consider a unified structure (a Domestic AIF acting as a master fund and a feeder vehicle in GIFT or other similar jurisdiction) or a co-investment structure with a Domestic AIF and an overseas vehicle (in GIFT or another similar jurisdiction) operating in parallel. A key point to note is that, in a unified structure, as long as the ownership and control of the manager and sponsor of the Domestic AIF are vested with Indian resident citizens, the investments made by the Domestic AIF are not subject to any FDI limitations.

GIFT Funds need not be limited to India-focused funds, and can be global funds raising capital from resident Indians or overseas investors.

Domestically, retail funds are regulated as Mutual Funds, as discussed in **3. Fund Formation**. GIFT Funds can also launch schemes for retail investors subject to the criteria specified under the FM Regulations.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Domestic AIFs and GIFT Funds

Under the AIF Regulations, a Domestic AIF may be set up in the form of a trust, a company, a limited liability partnership (LLP) or a body corporate.

Under the FM Regulations, a GIFT Fund intending to operate as a "venture capital scheme" or a "restricted scheme" may be set up in the form of a trust, a company or an LLP, while "retail schemes" can be set up in the form of a trust or a company.

Trust structures have been consistently adopted by the industry as the default standard for both Domestic AIFs and GIFT Funds due to their operational flexibility, for confidentiality reasons and because regulatory compliance requirements are less stringent versus those for structures such as an LLP or a company.

Domestic AIFs and GIFT Funds set up as trusts would be governed by the Indian Trusts Act, 1882, would be governed by the Companies Act, 2013 ("Companies Act") if set up as companies, and would be governed by the Limited Liability Partnership Act, 2008 ("LLP Act") if set up as LLPs, in addition to the AIF Regulations and the FM Regulations, respectively.

On making an investment, "units" are issued to the investors, evidencing beneficial interest in a particular scheme of a Domestic AIF or a GIFT Fund.

Choice of structure for managers

The managers of both Domestic AIFs and GIFT Funds are mostly structured in the form of an LLP or a company. For GIFT Funds, the manager may be structured as the branch of an entity which is already registered and/or regulated by a financial sector regulator in India or a foreign jurisdiction for conducting similar activities.

LLPs have relatively fewer compliance and regulatory requirements compared to companies. The costs incurred setting up and maintaining an LLP are also lower. LLPs are beneficial in cases where stakeholders wish to regularly withdraw profits since, once the LLP has discharged tax on its income, the distributions received by partners from the LLP are free of tax. However, LLPs are subject to a higher tax rate than companies. Companies may be preferred if the stakeholders do not intend to regularly withdraw profits as dividends, as tax on the distribution of dividends additionally applies to the recipients.

2.1.2 Common Process for Setting Up Investment Funds

Domestic AIFs

To begin the process of registration, the entity to be registered as a Domestic AIF must be set up under the applicable law.

- For private trusts, the trust deed is entered into between the settlor and the trustee, and is registered in accordance with the Registration Act, 1908.
- For companies and LLPs, incorporation is required under the Companies Act and LLP Act, respectively. The typical timeline for incorporation of a company or an LLP is three to six weeks.

Thereafter, the applicant is required to obtain a Permanent Account Number (PAN) and make an application via the SEBI Intermediary Portal (SI Portal) along with necessary documents and information. Some of the key requirements are as follows:

- AIF Regulations specify that an entity or an individual must be designated as a sponsor; the manager entity can also act as a sponsor.
- The manager entity would need to have a key investment team that meets the criteria of educational qualification and certification, as prescribed under the AIF Regulations.
- The manager/sponsor entity should be able to demonstrate adequate net worth to maintain the continuing interest specified (for Category I Domestic AIF – Angel Funds: 2.5% of the

corpus or INR50 lakhs, whichever is lower; for any other Category I or II Domestic AIFs: 2.5% of the corpus or INR5 crore, whichever is lower; for Category III Domestic AIFs: 5% of the corpus or INR10 crore, whichever is lower).

- A private placement memorandum (PPM), along with a merchant banker's certificate and the Domestic AIF's constitutive documents;
- KYC documents, financial documents, fulfilment of fit and proper criteria for a Domestic AIF, manager, sponsor, trustee, and their respective directors/partners, key investment team members and disclosure of any prior regulatory actions and such other related declarations as mandated under the AIF Regulations.

The approval process generally takes two to three months, and, after authorisation, the fund must pay the fee applicable to its Domestic AIF category. The SEBI takes a record of the PPM for the first scheme under the Domestic AIF at the time of registration itself, and the Domestic AIF can launch further schemes by filing a PPM and requisite information along with the required fees.

GIFT Funds

The Fund Management Entity or FME must identify office space with adequate infrastructure at GIFT City for the purposes of incorporation. Thereafter, an application may be made to IFSCA via the Single Window IT System (SWITS) for registration. Based on the type of funds to be managed, the FME may decide to apply as an Authorised FME, Registered FME (Non-Retail) or Registered FME (Retail).

Key requirements for all FMEs include the following.

- The appointment of key management personnel with experience required, based on the category of the FME. Key management personnel must be physically based out of GIFT City in order to demonstrate substance.
- Compliance with minimum net worth requirements of the FME:
- Authorised FME: USD75,000;
- Registered FME (Non-Retail): USD500,000; and
- Registered FME (Retail): USD1 million.

- Disclosures of any prior regulatory actions and declarations as mandated under the FM Regulations, etc.

The approval process generally takes two to two and a half months, and, after it has been approved, the FME can launch schemes based on the category of FME registration obtained. Also, an annual fee for renewal of FME registration is payable by the FME to the IFSCA.

Based on the FME category, Venture Capital Schemes, Restricted Schemes and Retail Schemes can all be launched in accordance with the FM Regulations.

2.1.3 Limited Liability

For companies and LLPs, there are statutory limits on the liability of shareholders and partners, respectively. For trusts, there is no statutory liability. Irrespective of the structure, fund managers ensure that the liability of investors is contractually limited for Domestic AIFs and GIFT Funds.

2.1.4 Disclosure Requirements

Domestic AIFs

The following disclosures must be made to investors.

- SEBI-mandated disclosures based on a detailed PPM template.
- An annual report including the financial details of investee companies, and other material information to be provided from time to time.
- Reports on changes to the PPM, fees and expenses, disciplinary history, contractual or regulatory breaches, etc.

The following disclosures must be made to the SEBI.

- Quarterly and annual compliance reports.
- Annual audit requirement of compliance with the PPM.
- Any material change in the information previously submitted.

On receipt of any foreign investment, or when the investments of the Domestic AIF are to be treated as indirect foreign investments due to the ownership of the manager or sponsor, additional reporting under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ("NDI Rules") may be applicable.

GIFT Funds

While the IFSCA does not prescribe a template for PPMs, it mandates minimum disclosures similar to the template PPM for Domestic AIFs.

Finally, FM Regulations prescribe certain reporting requirements to the IFSCA and investors that are less stringent than those prescribed for Domestic AIFs.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

For the quarter ending 30 September 2024, total funds raised from domestic investors in Domestic AIFs in India amounted to around Rs. 3,37,526 crore and 2,21,353 crore from foreign investors as per the statistics published by SEBI. Similar statistics released by the IFSCA as of 30 June 2024 suggest that commitments to the tune of USD11,693,910,000 have been raised by GIFT Funds. A diverse set of investors have shown interest in Domestic AIFs and GIFT Funds including high-net-worth individuals, family offices and institutional investors, as well as overseas development financial institutions, sovereign wealth funds and pension funds.

2.2.2 Legal Structures Used by Fund Managers

Please see **2.1.1. Fund Structures.**

2.2.3 Restrictions on Investors

Domestic AIFs

Domestic investors

Most investors can freely invest in Domestic AIFs, with certain specific limitations:

- *Insurance companies* Insurers are permitted to invest in Category I and Category II Domestic AIFs that make investments in specified sectors. The insurers must not invest in Domestic AIFs that invest in securities of companies outside India.
- *RBI regulated entities* Indian banks are limited to investing a maximum of 10% in the paid-up or unit capital of Category I or Category II Domestic AIFs. Banks are prohibited from investing in Category III Domestic AIFs. Indian banks, non-banking financial companies (NBFCs) and other entities regulated by the RBI are barred from investing in Domestic AIFs that have downstream investments in debtor companies (excluding equity investments).

Foreign investors

Foreign entities from Financial Action Task Force (FATF)-compliant jurisdictions are generally permitted to invest in Domestic AIFs under the automatic route under the Non-Debt Instruments Rules. Investors from countries sharing a land border with India or those with beneficial owners from these countries can invest through the government approval route. Foreign investors may prefer to invest via a feeder vehicle into Domestic AIFs to avoid the requirement of a permanent account number, or PAN.

Category III Domestic AIFs accepting foreign investment can only make portfolio investments in those securities authorised for a foreign portfolio investor.

GIFT funds

There are no specific restrictions on types of investors that can invest in GIFT Funds. Participation by Indian investors in GIFT Funds would be subject to Indian overseas investment laws.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Domestic AIFs

The main features of Domestic AIFs are as follows:

- *Diversification norms* Categories I and II Domestic AIFs cannot invest more than 25% (or 50% in the case of Large Value Fund for Accredited Investors (LVF)), and Category III Domestic AIFs cannot invest more than 10% (or 20% in the case of LVFs) of their investable funds in a single portfolio entity, whether directly or through investment in the units of other Domestic AIFs. The SEBI allows Category III Domestic AIFs to calculate their 10% (or 20% in the case of LVFs) investment concentration limit in one investee company either based on their investable funds or the net asset value of the fund if such Domestic AIFs are investing in listed equity.
- *Tenure:* Category I and II Domestic AIFs are closed-ended in nature, while Category III Domestic AIFs may be open-ended or closed-ended. Closed-ended Domestic AIFs must have a minimum tenure of three years.

Type of investment

- Category I Domestic AIFs generally invest in the securities of start-up or early-stage ventures, social ventures, SMEs, infrastructure or social impact funds, infrastructure funds, or special situation funds.
- Category II Domestic AIFs are required to invest primarily in the securities of unlisted companies, either directly or through investment in units of other Domestic AIFs.
- Category III Domestic AIFs may invest in the securities of listed or unlisted investee companies, derivatives, units of other Domestic AIFs, or complex/structured products.
- *Overseas investment:* Domestic AIFs must obtain prior approval from the SEBI to make overseas investments. These cannot exceed 25% of their investable funds and are subject to specified limits for Domestic AIFs in aggregate.

Minimum ticket size

- The minimum investment per investor for Domestic AIFs is INR10,000,000. Lower thresholds are available for employees and directors of the manager of the Domestic AIF, “accredited investors” and angel funds.
- For LVFs, the minimum commitment is INR700 million (about USD8.3 million).
- For angel funds, the minimum commitment by an angel investor is INR2.5 million (about USD30,000). The minimum corpus for Angel Domestic AIFs is INR5 crore.
- *Safe keeping of securities:* appointment of custodians is mandated under the AIF Regulations for the protection and safe keeping of

the securities. Also, as mentioned, a manager must ensure the separation of assets and liabilities, and that the bank accounts and securities accounts of each scheme floated under the AIF are segregated and ring-fenced.

GIFT Funds

There are no concentration norms applicable as such, although other conditions apply for investments that can be made by Venture Capital Schemes and Restricted Schemes. However, these are not as comprehensive as those applicable to Domestic AIFs.

Retail Schemes also have certain investment restrictions which are not as stringent as those applicable to mutual funds.

An overview of the various categories of GIFT Funds are as follows:

- *Venture Capital Schemes:* the minimum investment amount for each investor must be above USD250,000, and there can be no more than 50 investors. The minimum corpus raised must be USD5 million and the maximum can go up to USD200 million.
- *Restricted Schemes (Category I, II and III AIFs):* the investment commitment must be more than USD150,000, and there can be a maximum of 1,000 investors. The minimum corpus to be raised is USD5 million.
- *Retail Schemes and Closed-Ended Retail Schemes:* a minimum commitment of USD10,000 from each investor if the scheme is investing 15% or more in unlisted securities. There is no minimum for open-ended schemes or closed-ended schemes investing less than 15% in unlisted securities. They need to have at least 20 investors with no single investor holding more than 25% of the scheme. They must raise a minimum corpus of USD5 million.
- *Accredited Investors*: these are exempt from any minimum investment requirements for Venture Capital Schemes and Restricted Schemes.

2.3.2 Requirements for Non-Local Service Providers

Domestic AIFs

Service providers for Domestic AIFs primarily include custodians, merchant bankers, issue registrars and/or share transfer agents (to be appointed for the collection of stamp duty upon issuance and transfer of AIF units). These service providers must be registered with the SEBI and must have a presence in India. Certain local services providers, including trustees and benchmarking agencies, may not require SEBI registration to provide services to Domestic AIFs.

GIFT Funds

Custodians, distributors and depository participants offering services at GIFT City may be required to secure registration under the International Financial Services Centres Authority (Capital Market Intermediaries) Regulations, 2021 ("CMI Regulations"). Other service providers at GIFT City may also require registration with the IFSCA.

2.3.3 Local Regulatory Requirements for Non-Local Managers

Domestic AIFs

The manager entity of a Domestic AIF must be incorporated in India under the country's applicable laws. Foreign investment in the manager of a Domestic AIF may be made via the automatic route in accordance with NDI Rules.

If ownership and control of both the manager and sponsor of a Domestic AIF does not lie with

Indian resident citizens, investments made by the Domestic AIF in equity instruments – equities, compulsorily convertible preference shares or debentures, or warrants – of an Indian entity will be considered to be indirect foreign investment for the investee Indian entity, and would be subject to the sectoral caps, pricing guidelines and other conditions applicable for foreign investments set out under the NDI Rules.

GIFT Funds

GIFT does not have any specific requirements for non-local fund managers.

2.3.4 Regulatory Approval Process

Please see **2.3.2 Requirements for Non-Local Service Providers**.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

Domestic AIFs

Domestic AIFs are only permitted to raise funds by way of private placement after receipt of approval from the SEBI. Managers cannot publicly advertise investment offers.

Pre-marketing is not recognised as a concept under the AIF Regulations. In practice, pre-marketing is carried out in India by incorporating suitable disclaimers in pre-marketing pitchbooks and presentations so that it is distinguishable from any kind of (disallowed) public offer to subscribe to the units of a Domestic AIF.

GIFT Funds

Pre-marketing is not specifically recognised as a concept under the FM Regulations and/or other regulatory frameworks managed by the IFSCA. Pre-marketing at GIFT City is carried out by incorporating suitable disclaimers in pre-marketing pitchbooks and presentations so that it is distinguishable from any kind of general offer to subscribe to the units of GIFT Funds.

Please refer to the requirements for distributors in **2.3.6. Rules Concerning Marketing of Alternative Funds**.

2.3.6 Rules Concerning Marketing of Alternative Funds

Domestic AIFs

There is no specific regulatory framework for distributors, although the AIF Regulations govern the commission payable to distributors for marketing of units of Domestic AIFs on a private placement basis, as follows:

- AIFs must disclose the distribution/placement fee, if any applicable, to the investors;
- for Category III Domestic AIFs, any distribution/placement fees must be charged to investors on an equal trail basis, with no upfront fees, and any fees paid must come solely from the management fee received; and
- for Category I and II Domestic AIFs, up to one-third of the total distribution/placement fee may be paid to distributors upfront, with the remainder to be paid on an equal trail basis over the fund's tenure.

GIFT Funds

Distributors who wish to set-up operations in GIFT City and engage with an issuer or a service provider to facilitate investment or subscription in GIFT Funds, India funds or funds of any foreign jurisdiction must register with the IFSCA under the CMI Regulations prior to the commencement of operations. Distributors (registered or otherwise) would need to ensure compliance with the Code of Conduct prescribed by the IFSCA to distribute GIFT Funds on an ongoing basis.

2.3.7 Marketing of Alternative Funds

See **2.2.3 Restrictions on Investors**.

2.3.8 Marketing Authorisation/Notification Process

Domestic AIFs

Please see **2.1.2 Common Process for Setting Up Investment Funds**; **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**; and **2.3.6 Rules Concerning Marketing of Alternative Funds**.

GIFT Funds

Please see **2.1.2 Common Process for Setting Up Investment Funds**; **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**; and **2.3.6 Rules Concerning Marketing of Alternative Funds**.

2.3.9 Post-Marketing Ongoing Requirements

See **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds** and **2.3.6 Rules Concerning Marketing of Alternative Funds**.

2.3.10 Investor Protection Rules

Domestic AIFs

Each manager of a Domestic AIF must designate a staff member to address investor grievances.

SCORES (SEBI Complaints Redressal System)

If the investor remains dissatisfied with the response or resolution provided by the AIF, they can file a complaint on SCORES, the SEBI's online grievance redress platform.

ODR (Online Dispute Resolution) Portal

The ODR platform was set up to allow online conciliation and arbitration for resolution of disputes in the Indian Securities Market. Any investor may raise a dispute on this portal to seek online dispute resolution.

To ensure investor protection, the AIF Regulations require that approval be sought from a specified percentage of investors for certain decisions such as, among others, in specie distributions, early wind-up, term extension, transactions with associates and change of investment strategy.

AIF Regulations also lay down a strict code of conduct for Domestic AIFs, trustees, managers, key management personnel, and members of investment committees, ensuring high standards of governance and further protecting investor interests.

GIFT Funds

Investor protection norms similar to those applicable to Domestic AIFs have been established under the FM Regulations and circulars issued by the IFSCA for GIFT Funds.

2.3.11 Approach of the Regulator

Domestic AIFs

The SEBI has developed the SI Portal, which can be accessed for all relevant registration and post-registration activities under the AIF Regulations. The SEBI also offers an Informal Guidance Scheme under which investors, market intermediaries or other entities can seek guidance on any regulatory matters for a fee.

Meetings may be possible, depending on context.

GIFT Funds

An approach to that of the SEBI has been adopted by IFSCA officials. Meetings with IFSCA officials are possible.

2.4 Operational Requirements

Domestic AIFs

AIF Regulations and various circulars issued by the SEBI for market participants require the Domestic AIF/manager to adopt various policies covering areas such as risk, valuation, insider dealing and market abuse, and anti-money laundering.

Some key policies and its features are provided below.

Risk management

As per the applicable Code of Conduct, AIFs must ensure that an effective risk management process and appropriate internal controls are in place, including making disclosures to investors. Also, for investments in listed securities, the manager is mandated to adopt a stewardship code.

Valuation and pricing of the assets held by the fund

AIFs are required to follow standardised valuation practices per the AIF Regulations. For unlisted and thinly traded securities, valuations are based on the IPEV Guidelines.

Insider dealing and market abuse

SEBI (Prohibition of Insider Trading) Regulations, 2015 ("PIT Regulations") require the manager to formulate a code of conduct to regulate, monitor and report trading by designated persons and immediate relatives of the designated persons, as applicable in the case of certain AIFs.

Anti-money laundering

Domestic AIFs must adopt Countering the Financing of Terrorism (CFT) and anti-money laundering (AML) policies, inter alia, covering client due diligence, investor-risk categorisation, transaction monitoring and reporting to the Financial Intelligence Unit – India in the event of suspicious transactions. The appointment of a designated director and a principal officer to monitor implementation is required.

GIFT Funds

Please refer to **2.3.1 Regulatory Regime** for discussion of restrictions on the types of activity or investment made by Gift Funds and details of the regulations to protect Gift Fund assets.

GIFT Funds need to adopt various policies covering areas such as risk, valuation, insider trading, AML, etc, on lines similar to those adopted by Domestic AIFs.

Generally, GIFT Funds that are Restricted Schemes may undertake short selling subject to leverage limitations.

2.5 Fund Finance

Domestic AIFs

Category I and Category II Domestic AIFs

Category I and Category II Domestic AIFs may borrow funds to cover a drawdown shortfall for investments. The borrowed amount cannot exceed 20% of the proposed investment in the investee company, 10% of the fund's investable funds, or the pending commitment from investors, whichever is lower. Borrowing for day-to-day operational requirements cannot be for more than 30 days, on not more than four occasions in a year and the amount must not represent more than 10% of the investable funds.

Category III AIFs

Category III Domestic AIFs can borrow or use leverage – eg, by investing in derivatives or by borrowing or any other means – and must comply with the prudential requirements laid down by the SEBI. The leverage ratio of a Category III Domestic AIFs limited to two times the NAV of the fund, meaning the fund's exposure should not exceed twice its net asset value.

GIFT Funds

Venture Capital Schemes and Restricted Schemes are permitted to undertake borrowings without restriction, with the consent of investors and appropriate disclosures in PPM. Any change to the terms would require the consent of two-thirds of the investors by value.

Retail Schemes are permitted to borrow up to 20% of assets under management (AUM) for six months only to meet temporary liquidity needs for the purposes of redemption.

2.6 Tax Regime

Domestic AIFs

The Income-tax Act, 1961 ("IT Act") is the statute governing income taxes in India, and provides for a tax pass-through status to Category I and II Domestic AIFs – ie, their income is directly taxable in the hands of their investors as though it were received by or was accruing to them had they invested directly in the underlying securities. The tax pass-through status applies to all income earned by Domestic AIFs apart from income taxable under the heading "Profits and gains of business or profession". This business income is taxable at the maximum marginal rate applicable in that financial year and due by the Domestic AIF. Thereafter, this business income is tax-exempt for investors.

Category III Domestic AIFs are not granted the above pass-through status under the IT Act. However, if they are set up as trusts, they can be structured for tax transparency if the general principles of trust taxation and other provisions of the IT Act are applied.

Non-resident investors are eligible to claim the benefits of a double-taxation avoidance agreement, or Tax Treaty, entered into between their country of residence and India. The provisions of the Tax Treaty would supersede the provisions of the IT Act if they are more beneficial than the provisions of the latter, subject to other requirements and customary substance requirements. Where investors are from countries with which India does not have a Tax Treaty, the provisions of the IT Act will continue to apply.

GIFT Funds

GIFT Funds in the nature of Category I and Category II AIFs have been accorded a pass-through status similar to Domestic AIFs. Business income is eligible for a 100% tax holiday for ten years within the first 15 years. Non-resident investors enjoy tax exemption on offshore income made through GIFT Funds, and are not required to obtain a PAN or file a tax return in India. Losses (except for business losses) can be passed through to investors, provided units are held for 12 months or more. Investors are also eligible to claim benefits (if any) under the applicable double taxation avoidance agreements.

GIFT Funds are taxed at fund level, with exemptions for non-resident investors on income arising from the transfer of securities (other than the shares of Indian companies) such as derivatives, debt securities, offshore securities, mutual funds and specified securities listed on the IFSC exchanges.

FMEs enjoy a 100% corporate tax holiday for ten years within the first 15 years, reduced Minimum Alternate Tax/Alternate Minimum Tax rates and GST exemption on services provided to GIFT Funds.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Domestic Mutual Funds

Structure of mutual funds

Mutual funds are trusts set up under the Indian Trusts Act, 1882, through a registered trust deed. The trust is established by one or more sponsors, who are similar to the promoters of a company. It is registered with the SEBI under the MF Regulations as a mutual fund, and this fund can launch multiple schemes, each with assets and liabilities that are segregated and ring-fenced from other schemes of the mutual fund. The investors contributing to the schemes of a mutual fund are the beneficial owners of that scheme.

In addition, the sponsor establishes a trustee company in India which holds the property of the mutual fund for the benefit of the investors.

The trustee company of the mutual fund in turn appoints an Asset Management Company (AMC), a limited liability company incorporated in India, which is approved by the SEBI, for management of the mutual fund.

The decentralised structure of mutual funds in India ensures that a system of checks and balances is maintained. No party can unilaterally take a decision which may not be in the interests of the investors. However, a decentralised – versus leaner – structure also leads to increased reporting requirements and higher set-up and administration costs.

Retail Schemes under GIFT Funds

Please see **2.1.1 Fund Structures**.

3.1.2 Common Process for Setting Up Investment Funds

Domestic Mutual Funds

A mutual fund in India can initiate its operations and collect monies from investors and issue units to them only after obtaining prior approval from the SEBI, which is a two-step process.

- *In-principle approval to sponsor* – the sponsor must apply, filing Form A via an online portal, so that the SEBI can establish its eligibility to act as the sponsor of a mutual fund. The SEBI analyses the application to ensure that the sponsor has a sound track record and a general reputation of fairness and integrity in all business transactions, meets all criteria as a fit and proper person, has at least five years' experience in financial services, and has a solid financial position. The SEBI also analyses a business plan submitted by the sponsor to assess the reasons why the latter wishes to enter into the mutual fund business. Any queries are raised by the SEBI during its evaluation and an on-site visit to the office of the sponsor is carried out. The process generally takes six to 12 months.
- *Final approval for registration as a mutual fund* – after receipt of in-principle approval, the sponsor is given six months to file a final application. During this period, the sponsor is required to either incorporate a new AMC or create a clearly demarcated division for mutual fund business in an existing business and infuse it with necessary capital. This can be INR50 crore or INR150 crore, depending upon the conditions of past financial performance and business experience. The sponsor will incur the cost of setting up infrastructure, such as IT architecture, Business Continuity Planning and Disaster Recovery Sites, as well as expenses incurred hiring personnel and engaging vendors and intermediaries in

accordance with the MF Regulations. The sponsor is also required to incorporate a new trustee company with at least two-thirds independent directors. A final application in the prescribed format is then filed with the SEBI providing the relevant details on the AMC and the trustee company. These details cover various write-ups from the AMC, including the business plan, details of their physical and information technology systems, details about their directors and personnel and strategy to sustain operations during the start-up phase if the AMC does not make a profit. The SEBI evaluates the sponsor's eligibility based on the application filed, responses made to the SEBI's questions and an on-site visit to evaluate the preparedness of the AMC to undertake mutual fund business. Final approval from the SEBI for registration of the mutual fund can take another four to six months.

The sponsor is also required to pay INR5 lakhs plus taxes at the time of filing the application for in-principal approval, and a fee of INR25 lakhs plus taxes after final approval is granted.

To sum up, it generally takes 15 to 20 months for the SEBI to analyse and satisfy itself that a sponsor, AMC and trustee company are fit to launch and manage a mutual fund, and for the entire mutual fund application to be approved.

Launch of mutual fund Schemes:

After seeking registration as a mutual fund, the AMC can launch mutual fund schemes by filing the relevant documents – ie, a Scheme Information Document (SID), providing the key features of the scheme of a mutual fund; a Statement of Additional Information (SAI), which provides standard terms of engagement of the AMC with respect to mutual funds, as well as other terms and conditions with respect to investments, redemptions and restrictions; and a Key Information Memorandum (KIM), which provides a brief snapshot of the scheme, and the details for various entities, fund managers and key investment personnel involved in the operations of the mutual fund.

The first mutual fund scheme must be launched within six months of the date of receipt of mutual fund registration.

Any subsequent schemes, on which SEBI observation letter has been issued, can be launched by filing a draft SID with the SEBI at least 8 working days prior to launch of the new mutual fund schemes for public comments. During this period public comments are invited on the adequacy of disclosures made in the document.

Retail Schemes Under GIFT Funds

See **2.1.2 Common Process for Setting Up Investment Funds**

3.1.3 Limited Liability

Domestic Mutual Funds

Liability of the investors is limited to the number of units they hold in the schemes of the Mutual Fund, and they do not have any personal liability.

Retail Schemes under GIFT Funds

See **2.1.3 Limited Liability**.

3.1.4 Disclosure Requirements

Domestic Mutual Funds

Disclosures made under fund documents

Mutual funds are required to make disclosures through various fund documents such as the aforementioned SID, SAI and KIM which should be filed with the SEBI and circulated among investors.

Periodic reporting

The mutual fund's AMC is required to make various disclosures on daily, monthly, quarterly, half-yearly and yearly basis to the investors, trustees of the mutual fund and SEBI, such as daily disclosure of net asset value, a quarterly report to the trustee on operations of the mutual fund, an annual report to the SEBI and investors, intimations of any deviations from the scheme's objective, etc.

Retail Schemes under GIFT Funds

See **2.1.4 Disclosure Requirements**.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

Domestic Mutual Funds

The Indian retail market has seen a remarkable surge in activity among several investor categories, including individual retail investors, institutional investors, domestic and foreign investors, high-net-worth investors and non-resident investors. This is reflected in the exponential increase in the mutual fund segment's AUM from INR27.05 trillion as on 30 November 2019 to INR68.08 trillion on 30 November 2024, according to the AMFI.

Retail Schemes under GIFT Funds

See **2.2.3 Types of Investors in Alternative Funds**

3.2.2 Legal Structures Used by Fund Managers

Domestic Mutual Funds

Mutual Funds are managed by an asset management company (AMC) which is structured as a limited liability company under the Companies Act, 2013.

Retail Schemes Under GIFT Funds

Please refer to **3.2.2 Legal Structures Used by Fund Managers**.

3.2.3 Restrictions on Investors

Domestic Mutual Funds

There are no restrictions on investors making investments in mutual funds. However, they must meet the conditions of the Prevention of Money Laundering Act, 2002, and adhere to the SEBI's "Guidelines on Anti-Money Laundering (AML) Standards and CFT/Obligations of Securities Market Intermediaries under the Prevention of Money Laundering Act, 2002 and Rules Framed Thereunder" ("AML/CFT Guidelines") setting down the AML KYC guidelines. Further, under these guidelines, the mutual fund is required to ensure that the investor is from a competent jurisdiction, is not a Politically Exposed Person (PEP) and is not undertaking any dubious or unusual transactions.

With respect to investment in mutual funds by persons resident outside India, certain jurisdictions restrict solicitation of foreign funds and accordingly, mutual funds may impose conditions on such investors at the time of onboarding them.

Retail Schemes Under GIFT Funds

See **2.2.3 Restrictions on Investors**

3.3 Regulatory Environment

3.3.1 Regulatory Regime

Domestic Mutual Funds

Investment restrictions

Various restrictions on investments by a mutual fund scheme are covered by Regulation 44(1) read with Schedule VII of the MF Regulations. These include limits with respect to exposure in various instruments, issuer company, and group-level restrictions. They are presented in order to ensure that, while investment decisions are made by the AMC, a balanced view is taken given the exposure inherent in certain instruments. For instance, the scheme must not invest more than 10% of its NAV in debt instruments rated investment grade (ie, BBB-) and above and issued by a single issuer, comprising money market instruments and non-money market instruments. A mutual fund should also not own more than 10% of any company's paid-up capital carrying voting rights.

Further, an industry-wide limit of USD7 billion has been set for overseas investments, with a USD1 billion cap per individual mutual fund.

Retail Schemes Under GIFT Funds

See **2.3.1 Regulatory Regime**

3.3.2 Requirements for Non-Local Service Providers

Domestic Mutual Funds

Under MF Regulations, a mutual fund can only engage with SEBI-registered intermediaries. If any entity is not required to be registered with the SEBI, it can be engaged only in terms of compliance, with outsourcing conditions laid down by the SEBI. Further, AMCs are restricted from carrying out operations relating to including trading, investor servicing and investor operations outside India.

Retail Schemes Under GIFT Funds

See **2.3.2 Requirements for Non-Local Service Providers**.

3.3.3 Local Regulatory Requirements for Non-Local Managers

Domestic Mutual Funds

Under the MF Regulations, a sponsor of a Mutual Fund shall be required to appoint or incorporate an AMC in India, which will undertake fund management activities for the Mutual Fund. However, an asset management company can be formed by a sponsor which is a non-resident Indian entity and the same is permissible under automatic route as per the Foreign Direct Investment Policy.

Retail Schemes Under GIFT Funds

See **2.3.3 Local Regulatory Requirements for Non-Local Managers**.

3.3.4 Regulatory Approval Process

Domestic Mutual Funds

See **3.1.2 Common Process for Setting Up Investment Funds**.

Retail Schemes Under GIFT Funds

See **2.3.4. Regulatory Approval Process**.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Domestic Mutual Funds

There is no pre-marketing of mutual fund schemes in India.

Retail Schemes Under GIFT Funds

See **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**.

3.3.6 Rules Concerning Marketing of Retail Funds

Domestic Mutual Funds

As mentioned, at the time of investor on-boarding, all fund documents – SID, SAI and KIM – must be made available to investors.

- *Marketing by AMCs* – under MF Regulations, the SEBI's Advertisement Code lays down the conditions for all forms of communication issued, including any advertisements, with respect to the marketing of mutual fund schemes. However, any form of advertise-

ment issued by a mutual fund must be submitted to the SEBI within seven days of the date of issuance, along with an undertaking by the compliance officer of the AMC that the advertisement adheres to the Advertisement Code prescribed under the MF Regulations.
- *Selling of Mutual Fund Schemes by Distributors* – a mutual fund may empanel a Mutual Fund Distributor (MFD) registered with the Association of Mutual Funds in India (AMFI), a non-profit body of the AMCs of all mutual funds registered with the SEBI that lays down best practices and standardised operational guidelines for uniformity among all AMCs. MFDs are required to comply with the Code of Conduct for MFDs prescribed by the AMFI. The mutual fund will also be liable in the event of misconduct (such as mis-selling, form splitting, etc) by MFDs empanelled by them.

Retail Schemes Under GIFT Funds

See **2.3.7 Marketing of Alternative Funds**.

3.3.7 Marketing of Retail Funds

Domestic Mutual Funds

In India, there are no specific restrictions as to whom the mutual funds can be marketed. It can be marketed to the general public at large, subject to compliance with marketing rules as prescribed above.

Retail Schemes Under GIFT Funds

See **2.3.7 Marketing of Alternative Funds**.

3.3.8 Marketing Authorisation/Notification Process

Domestic Mutual Funds

See **3.3.6 Rules Concerning Marketing of Retail Funds**.

Retail Schemes Under GIFT Funds

See **2.3.8 Marketing Authorisation/Notification Process**.

3.3.9 Post-Marketing Ongoing Requirements

Domestic Mutual Funds

See **3.3.6 Rules Concerning Marketing of Retail Funds**.

Retail Schemes Under GIFT Funds

See **2.3.9 Post-Marketing Ongoing Requirements**.

3.3.10 Investor Protection Rules

Domestic Mutual Funds

The SEBI has introduced various structures and measures to safeguard investor interests, including the following.

- A Unitholder Protection Committee set up by the AMC to establish policies and systems for reviewing and addressing investor grievances in a timely manner and to help reduce investor complaints.
- The appointment of Investor Relations Officer by the AMC (whose details are generally presented in the SID and on the website of the relevant mutual fund) whom investors can approach should they have any grievances.
- SCORES, an online centralised grievance redressal system which allows investors to file complaints against the mutual fund and ensure timely treatment.
- An online Dispute Resolution Mechanism for conciliation and arbitration in the event of disputes arising between a mutual fund and its investors.

Retail Schemes Under GIFT Funds

See **2.3.10 Investor Protection Rules**.

3.3.11 Approach of the Regulator

Domestic Mutual Funds

The SEBI is known for its approachability and proactive engagement with investors and market participants.

During the process of evaluating mutual fund applications, SEBI officials actively liaise with a designated contact from the applicant organisation to address queries, request additional information, and ensure a smooth application process. This approach reflects SEBI's commitment to transparency and effective communication.

The SEBI also offers an Informal Guidance Scheme under which market intermediaries or other entities can seek its written guidance by paying a prescribed fee on any regulatory matters.

Retail Schemes Under GIFT Funds

See **2.3.11 Approach of the Regulator**

3.4 Operational Requirements

Domestic Mutual Funds

Categories of mutual fund schemes

The schemes of a mutual fund can be split into two categories, as follows:

- *According to maturity period* – a mutual fund scheme can be open-ended, without any fixed-maturity period, or close-ended, where investors can subscribe only during a specified period and thereafter, they can buy or sell the units of the scheme on the stock exchanges where the units are listed) based on maturity period.
- *According to investment objective* – a scheme can be classified as a growth-/equity-oriented scheme, which invests a large part of its corpus in equities; an income/debt scheme, which generally invest in fixed income securities, such as bonds, corporate debentures, government securities and money market instruments; a balanced/hybrid scheme, investing in equities and fixed income securities in the proportion indicated in its offer documents; a gilt fund, which exclusively invests in government securities; or index funds, which replicate the portfolio of a particular index, such as the BSE Sensitive index (Sensex), the NSE 50 index (Nifty), etc, based on its investment objective.

Asset Protection

The mutual fund is mandated to appoint a SEBI-registered custodian to hold the securities in which the mutual fund schemes will invest. The SEBI must be informed of the appointment of the custodian within 15 days of the appointment date. The trustees are responsible for the funds and property of the schemes and must hold them in trust for the unitholders, in accordance with MF Regulations.

Policy requirements

Some of the key policies and frameworks adopted by a Mutual Fund to ensure effective management of the schemes are as follows.

- *Risk Management Framework* – introduced by the MF Regulation, which must be adopted by Mutual Funds. The framework lays down a set of principles or standards which, inter alia, comprise the policies, procedures, risk management functions and roles and responsibilities of the AMC and trustee company for balancing risks, in the operation of the schemes, affecting the interests of the investors. The elements of the framework have been split into mandatory sections, which must be implemented by the AMCs, and recommended elements, which can be considered for implementation. The AMCs must assess their framework and practices and submit a report to their board of directors, along with a road map for its implementation.

- *Investment Policy* – this must be maintained by the AMC which guides its team in their investment decisions, as well as asset allocation.
- *Valuation Policy* – laid down byunder the MF Regulations, this must be adopted by the AMC. It covers how to calculate the fair value of assets to ensure a consistent valuation methodology across all mutual funds. This policy is also disclosed to the investors.
- *Insider Trading Policy* – SEBI has mandated the AMCs to put in place an institutional mechanism for identification and deterrence of market abuse. This should consist of enhanced surveillance systems, internal control procedures and escalation processes so that specific types of misconduct, including front running, insider trading and misuse of sensitive information, etc, can be monitored and addressed. It is mandatory that the Insider Trading Policy be adopted by all the parties to the mutual fund in terms of PIT Regulations.
- *Anti-Money Laundering (AML) Policy* – this must be adopted by AMCs under the terms of the AML/CFT Guidelines which are similar to those adopted by Domestic AIFs.
- *Conflict of Interest Policy* – this covers checks to mitigate actual/potential conflicts and to ensure arms-length conduct whilst performing multiple activities, segregation of investors, segregation of personal interest of employees, etc.

Retail Schemes Under GIFT Funds

See **2.4 Operational Requirements**

3.5 Fund Finance

Domestic Mutual Funds

Borrowings

Mutual Funds cannot borrow unless it is to meet temporary liquidity needs (which cannot be more than 20% of NAV) for the purposes of repurchases, redemption of units or payment of interest or dividends to unitholders. The duration of borrowing cannot exceed a period of six months. The costs of borrowing for a given mutual fund scheme must be adjusted against the portfolio yield of the scheme and the borrowing costs in excess of portfolio yield, if any, will be borne by the AMC.

If an associate of the sponsor or AMC is the borrower, disclosure must be provided to the trustee and investors regarding the reasons for borrowing and the competitiveness of the terms of the borrowings.

Also, any general borrowings by AMCs must be disclosed to trustees and investors.

Retail Schemes Under GIFT Funds

See **2.5 Fund Finance**

3.6 Tax Regime

Domestic Mutual Funds

Mutual funds are tax exempt, in accordance with the provisions of Section 10(23D) of the IT Act. The funds receive their income without any deduction of tax at source.

For investors, units of a mutual fund held for more than 12 months are treated as long-term capital assets. The capital gain is charged after deduction of expenditure incurred wholly and exclusively on this transfer and cost as inflated by the cost-inflation index released by the Central Government of India for unitholders.

Individuals and Hindu Undivided Families (HUF) whose total income excluding long-term capital gains falls below the threshold of income, chargeable to tax, this shortfall must be deducted from the long-term capital gain and only the balance of the gain will be chargeable to tax.

Any loss arising from the sale of units can be deducted from the other capital gains of the investor; however, the deduction will only be made from the capital gains, and any capital loss must be carried forward separately to be offset against capital gains in the next year.

Retail Schemes Under GIFT Funds

See 2.6 Tax Regime.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Domestic AIFs have seen various regulatory changes over the last few years. The SEBI has implemented several measures to strengthen AIF governance, including standardising PPMs, requiring merchant banker sign-off on PPM disclosures, issuing detailed valuation guidelines, and imposing specific due diligence requirements to prevent regulatory arbitrage.

Recent regulatory amendments aim to curb the misuse of AIFs for achieving "qualified buyer" or "qualified institutional buyer" status without meeting independent eligibility criteria. Additionally, AIFs with significant involvement of RBI regulated entities are subject to enhanced scrutiny to address concerns over evergreening of stressed loans and circumvention of RBI regulations. The SEBI has also imposed stricter due diligence measures on Domestic AIFs with majority investment from countries sharing a land border with India.

The SEBI has also introduced a certification for managers' key investment team members, replacing the previous financial services experience requirement. This change is expected to reduce entry barriers for new arrivals. The SEBI also addressed the long-standing issue of unliquidated investments at the end of the tenures of Domestic AIFs by introducing a framework for extensions (continuation funds) and in specie distributions.

Fund managers remain bullish on the Indian alternatives market, since the SEBI's increased scrutiny is driven by a belief that stringent adherence to regulatory obligations and standards will foster trust, enabling the introduction of more relaxed regulations and making it easier to do business for Domestic AIFs.

The SEBI has also recently notified two important updates with respect to mutual funds. Firstly, it has introduced the "Specialized Investment Fund", a new product with a higher risk threshold which is intended for investors with a higher appetite for risk and offers greater flexibility and a higher ticket size. The SEBI has also introduced a simplified regime for index funds, MF Lite, where the AMCs will have leaner regulatory compliance requirements based on lower risk and a simplified product structure. The two amendments also reflect the SEBI's intention to balance its own regulatory ambit with evolving market needs.

In recent years, GIFT City has also emerged as a prominent international financial services hub. Its ranking improvement in the Global Financial Centres Index 2024 reflects its growing appeal, and the Indian government has expressed its commitment to promoting GIFT City's development.

The SEBI's amendments allowing increased participation by non-resident Indians, overseas citizens of India, and resident Indian individuals in GIFT City-based FPIs, along with the introduction of IFSCA's Single Window IT System (SWIT System), have further enhanced GIFT City's attractiveness. The SWIT System streamlines the application process and brings together various government agencies and regulators on a single digital platform.

The Union Budget 2024-2025 extends the period for tax exemptions in GIFT City until 31 March 2030, and brings about changes simplifying the process for Retail Funds and Exchange Traded Funds in foreign jurisdictions to relocate to GIFT City. This, coupled with the recently introduced IFSC (Listing) Regulations, 2024, which enable the direct listing of securities and financial products on IFSC stock exchanges, should further strengthen GIFT City's position as a competitive international financial hub.

Trends and Developments

Contributed by:
Tejesh Chitlangi, Sushreet Pattanayak, Pooja Mehta and Anita Jain
IC Universal Legal

IC Universal Legal is considered India's top law firm in the financial services legal-regulatory space, including investment funds. The firm has eight offices and 200 lawyers across the country, and provides end-to-end solutions for the full life cycle of funds, from set-up to obtaining regulatory licenses to limited partnership negotiations to deployment in investee companies. IC Universal Legal represents some of the India's largest private equity funds, such as Kedaara, TVS Capital, Xponentia and True North, as well as some of the world's largest India-centric foreign Venture Capital Funds, such as Matrix, Peak XV (formerly Sequoia India) and Lightspeed. The Firm has been ranked as a Band 1 Firm in Investment Funds by Chambers and Partners.

Authors

Tejesh Chitlangi is joint managing partner of IC Universal Legal. He is one of the most quoted securities lawyers in India, and is considered an authority in the Indian financial services legal regulatory space. Tejesh is a member of several regulatory working groups and committees, including the prestigious SEBI Alternative Investment Policy Advisory Committee (AIPAC) and the first Expert Committee on Investment Funds set up by the International Financial Services Centres Authority (IFSCA). He is a regular speaker at global events. Tejesh has consistently been ranked a Band 1 lawyer in Investment Funds by Chambers and Partners.

Sushreet Pattanayak is an accomplished corporate lawyer at IC Universal Legal with a strong focus on investment funds and asset management. Having worked with both established institutional clients and first-time wealth managers, he has over a decade of experience advising clients on a diverse range of subjects. These include fund formations for both India-focused and global funds across diverse asset classes, LP onboarding and negotiations, asset management company buyouts, inbound and outbound investment structures, securities laws, and on day-to-day legal and regulatory matters.

Pooja Mehta advises leading domestic fund managers, asset management companies and first-time fund managers for IC Universal Legal on the formation, registration, and documentation of alternative investment funds, including private equity, hedge, venture capital, real estate funds and debt funds. She has played a pivotal role in representing fund managers in various LP-GP negotiations against global DFIs, family offices and domestic institutions. Pooja also has significant experience structuring India-focused offshore funds, including setting up funds in GIFT City. She regularly liaises with the SEBI and IFSCA as part of their various policy initiatives on investment funds.

Anita Jain has extensive expertise in advising on investment funds, including the formation of funds in infrastructure, debt and credit, real estate, and private equity, as well as the legal and commercial aspects of their operation. She also specializes in structuring carried interest and co-investment arrangements. Anita provides strategic counsel to investment managers on managing private investment funds and asset management structures. Her expertise covers financial services, financial regulations, securities laws, and strategies for both inbound and outbound investments. She has advised some of India's leading Asset Management Companies on legal and regulatory matters, investments, and acquisitions.

IC Universal Legal

IC Universal Legal
209, Hubtown Solaris
Prof NS Phadke Marg
Andheri East
400069 Mumbai
India.

Tel: +91 (22) 6184 9901
Email: tejesh.chitlangi@icul.in
Web: www.icul.in

IC
UL
IC UNIVERSAL
LEGAL
Advocates & Solicitors

INDIA TRENDS AND DEVELOPMENTS

Contributed by: Tejesh Chitlangi, Sushreet Pattanayak, Pooja Mehta and Anita Jain, **IC Universal Legal**

Regulatory Developments

Domestic AIFs

The International Monetary Fund continues to be optimistic about India's economic prospects, raising its GDP growth forecast for FY 2024-25 to 7%. A diverse set of investors looking to participate in India's growing economy are increasingly turning towards investment products in the form of SEBI-regulated AIFs, tailored to their specific investment goals and risk appetites.

The past few years have seen a surge in regulatory activity surrounding AIFs, with the SEBI implementing several measures to ensure that enhanced governance norms are adopted by AIFs so that their growth is sustainable.

Some of these measures are encapsulated below.

- *Dematerialisation* the SEBI has mandated for all AIF investments made on or after 1 October 2024 to be held in dematerialised form. AIF schemes with tenure ending on or before 31 January 2025, or those already in their extended tenure, have been exempted from this requirement. In addition, the SEBI mandated that all AIFs issue units to investors in dematerialised form only. The aim is to streamline the management of AIF/investors' holdings by standardising ownership and by transfer tracking, reducing the potential for operational errors, and ensuring enhanced regulatory oversight.
- *Custodians* – to improve custodial oversight, the SEBI now requires the appointment of a custodian before the first investment is made by any new AIF scheme, regardless of the fund's corpus size. Previously, this requirement applied only to Category I and II AIFs with a corpus exceeding INR 500 crore, and all category III AIFs. This change ensures that robust custodial safeguards are in place from the outset, reducing risks in the early stages of the investment process. This expansion broadens custodial oversight to smaller funds that were previously exempt. The SEBI has emphasised that custodians affiliated with the fund manager or sponsor must comply with Regulation 20(11A) of the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations), ensuring independent custodial oversight to curb conflicts of interest within the ecosystem. By mandating dematerialisation and strengthening custodial oversight, the SEBI is mitigating operational risks while improving governance and transparency within the AIF space.
- *Valuation* – the SEBI has implemented a standardised approach for the valuation of investment portfolios aiming to ensure fair and transparent disclosure of portfolio values to investors. The valuation of securities, other than unlisted securities and listed securities that are non-traded and thinly traded, for which valuation norms have been laid down by the SEBI (Mutual Funds) Regulations, 1996, must be carried out in accordance with the above regulations, and valuation of unlisted securities and listed securities that are non-traded and thinly traded must be carried out in accordance with the International Private Equity and Venture Capital Valuation (IPEV) Guidelines. This initiative ensures that valuation principles, methodologies, and standards are consistent across the AIF industry. As a result, the performance of individual AIFs, as well as the overall AIF sector, can be benchmarked based on a uniform valuation methodology, reflecting their performance in a fair and accurate manner.
- *Dissolution period* – a "dissolution period" for AIFs has been introduced, allowing fund managers to manage unliquidated investments beyond the original tenure of AIFs providing

opportunity to the fund manager to implement an exit plan in an efficient manner. This addresses situations where specific investments within a fund cannot be liquidated due to unfavourable market conditions. For instance, certain assets may be difficult to sell without incurring substantial losses, due to a lack of market liquidity.

- *Encumbrance at investee entity level* – the SEBI now permits Category I and II AIFs to create encumbrances on the equity of investee entities for borrowings related to infrastructure projects. The aim is to promote greater investment in the critical infrastructure sector.
- *Revision of eligibility* – *criteria* the SEBI has revised the eligibility criteria for key investment team members of AIFs, replacing mandatory work experience requirements with certification criteria. At least one member of the key investment team must now pass the NISM Series-XIX-C certification exam. This change lowers the regulatory threshold for first-time fund managers, making it easier for new entrants to join the industry.
- *Pro rata and pari passu rights for investors* – recent regulatory amendments have ensured that investors in AIFs have pro rata rights in each investment and the distribution proceeds from such investment, in line with their capital commitment, ensuring fairness in pooled investment vehicles. Further, these amendments mandate that, except as specifically permitted, the rights of all investors in an AIF must be pari passu in all respects. Fund managers must now ensure that any side-letter terms being offered to specific investors must be covered within the positive list of differential rights. These regulatory amendments highlight the SEBI's commitment to enhancing investor protection, and fund managers will need to reassess their operational structures to balance customisation with compliance.
- *Migration of Venture Capital Funds* – earlier this year, the SEBI introduced guidelines facilitating the migration of Venture Capital Funds (VCFs) registered under the erstwhile SEBI (Venture Capital Funds) Regulations, 1996, to the AIF Regulations. This initiative aims to provide VCFs with flexibility in managing unliquidated investments upon the expiry of their tenure. VCFs opting for migration must apply to the SEBI. The guidelines specify conditions based on the status of VCF schemes, including provisions for tenure determination and additional liquidation periods. Non-migrating VCFs will be subject to enhanced regulatory reporting or potential regulatory action. This move is intended to align older funds with the current regulatory environment, ensuring better investor protection and compliance with updated SEBI guidelines.
- *Proposed changes to the Angel Fund Regime* – The SEBI has suggested raising the upper limit for investments in a single start-up from INR10 crore to INR25 crore, allowing angel funds to support more capital-intensive start-ups. Another proposal is to only allow accredited investors to invest through angel funds and to reduce the minimum lock-in period to six months. These changes are designed to adapt to the evolving start-up ecosystem in India, encourage greater participation by investors, and make angel funds more competitive globally while maintaining robust investor protection and regulatory oversight.

Retail funds in India

Some of the recent regulatory changes introduced with respect to the mutual funds industry include the following.

- An institutional mechanism for the identification and deterrence of market abuse, including front-running and fraudulent transactions in securities, using an alert-based surveillance system that each AMC will be required to implement. The mechanism also involves an escalation matrix, reporting requirements, and a whistle-blower policy.

- Introduction of "Specialized Investment Fund", a new product with a higher-risk threshold intended for investors with a larger risk appetite, offering greater flexibility and a higher ticket size to meet the needs of this emerging category of investors.
- Introduction of a simplified regime for index funds, MF Lite, where the AMCs will have leaner regulatory compliance requirements based on lower risk and a simplified product structure.
- Modification of conditions related to investments in overseas mutual funds/unit trusts by mutual funds permitting investments in overseas funds which have exposure to Indian securities, provided that exposure to Indian securities by such overseas funds corresponds to not more than 25% of their assets.
- Amendments to regulations to ease investment conditions for investments made in listed securities of group companies of the sponsor representing more than 25% of the net assets of the scheme of the mutual funds through equity-oriented exchange traded funds and index funds.
- Simplification of the format of the Scheme Information Document (SID), in consultation with the Association of Mutual Funds in India (AMFI), to enhance readability and streamline preparation, with all mutual funds required to comply.
- Recent notification by the SEBI of enforcement of insider trading regulations to bring mutual fund units under the ambit of insider trading norms (these had previously been excluded), ensuring enhanced regulatory compliance within the industry.

In addition, the SEBI has proposed to change the "skin-in-the-game" conditions for they key management personnel and investment teams of mutual funds in order to make them less onerous to key management personnel while ensuring that the spirit of the law is upheld. It has now been proposed to exclude the non-cash component while determining the minimum contribution by key management personnel in the schemes managed by a mutual fund, as well as evaluate the functional role of such key personnel.

GIFT AIFs

In recent years, GIFT City has emerged as a prominent international financial services hub, complementing the growth of domestic AIFs. The city has attracted numerous fund managers catering to both Indian and foreign investors, with its ranking improving from 67th to 57th in the Global Financial Centres Index 2024. The Honourable Minister of Finance and Corporate Affairs, Ms. Sitharaman, has emphasised GIFT City's role in India's vision to become a developed nation by 2047.

The government's commitment to promoting GIFT City is evident through amendments to the SEBI (Foreign Portfolio Investors) Regulations, 2019, which allow up to 100% aggregate participation by non-resident Indians, overseas citizens of India, as well as resident Indian individuals in FPIs based out of GIFT City. The introduction of the IFSCA's Single Window IT System (SWIT System) has further enhanced GIFT City's appeal by streamlining the application process and bringing various government agencies and regulators onto a single digital platform.

GIFT City is a competitive alternative to other traditional financial hubs such as Singapore or Mauritius, particularly given India's strong compliance with international Know-Your-Customer (KYC) and Prevention of Money Laundering (PMLA) norms. Additionally, the newly introduced IFSCA (Listing) Regulations, 2024, which allow the direct listing of securities and financial products on IFSC stock exchanges, should further boost GIFT City's attractiveness for capital raising.

Additionally, the IFSCA has recently approved amendments to the IFSCA (Fund Management) Regulations, 2022. These approvals include reduction in the minimum corpus amount of the scheme for both non-retail and retail schemes. Further, the contribution from the fund management entity/its associates to the corpus of a non-retail scheme, presently restricted at 10%, will now be permitted up to 100%. The proposed changes also intend to liberalise regulatory requirements with respect to the number and change of key managerial personnel, valuation of fund-of-funds schemes and validity of the tenure of the private placement memorandum, among other modifications.

Market Trends

Some of the key market trends observed over the last year are as follows.

Rise of private credit funds

The Indian private credit market has seen explosive growth, driven by a significant credit gap for Small and Medium Enterprises (SMEs) that are under-served by traditional banks. This gap, coupled with the allure of higher potential returns compared to traditional fixed-income investments, has attracted significant investor interest. Furthermore, private credit offers attractive diversification benefits for investors seeking to reduce their reliance on traditional asset classes like equities and bonds.

This demand has spurred the emergence of diverse private credit funds, including those specialising in structured credit and special situations.

Secondaries/buyout funds

The Indian secondaries and buyout market has also seen robust growth, underpinned by the maturing private equity ecosystem. A consistent increase in the number and size of private equity investments has been observed in the Indian market, creating a larger pool of potential buyout and secondary targets.

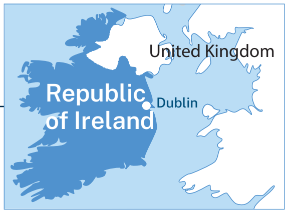
This maturing ecosystem has also led to a growing need for liquidity. Many private equity investors are seeking liquidity for their existing investments, creating a robust market for secondary transactions. Secondary transactions appear to serve as a means for investors to realise returns and rebalance their portfolios.

Furthermore, buyout funds are actively pursuing consolidation opportunities within various sectors, driving industry consolidation.

Conclusion

The AIF industry in India has made significant strides in investor protection and regulatory transparency in recent years. These advances have created an environment that aligns with international best practices, boosting confidence among both domestic and global investors. This robust regulatory framework, coupled with the rise of GIFT City as a prominent international financial hub, positions India as an attractive destination for international capital flows. Concurrently, the evolution of the retail funds segment, with innovations such as MF Lite and a focus on investor education, is broadening access to investment opportunities for a wider segment of the population.

IRELAND



Law and Practice

Contributed by:
Nicholas Blake-Knox, Jonathan Sheehan, Damien Barnaville and Joe Mitchell
Walkers

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Walkers is a market-leading financial services law firm that practises law across six jurisdictions and has ten offices across the Americas, EMEA and Asia. The Irish office provides Irish legal, tax, listing and professional services solutions to local and international financial institutions, investment managers, hedge funds, private equity groups and corporations. Walkers' experienced asset management and investment funds group offers expert advice and commercial solutions to many prominent asset managers, fund promoters and institutional investors, on investment fund strategies such as private equity, hedge and real estate as well as more traditional retail-focused products such as UCITS and retail AIFs. It is well placed to advise on the commercial and regulatory implications of the establishment and operation of investment fund structures in Ireland. The firm's independent corporate services offering, Walkers Professional Services, provides a broad range of corporate, fiduciary and administration services to structured and asset finance vehicles.

Authors

Nicholas Blake-Knox is a partner and head of the asset management and investment funds group at Walkers. He advises asset management firms on asset management and investment fund-related matters, and has experience across a wide range of asset classes and investment strategies, with particular expertise in advising managers of fixed income and debt-focused investment strategies, as well as less liquid alternative strategies. In 2022, he was elected for a three-year term to the Council of Irish Funds, and he is currently IF Chair. Nicholas has spoken at investment fund conferences and is a member of the Advisory Council of the Certified Investment Fund Director Institute.

Jonathan Sheehan is the managing partner of Walkers' Ireland office, where he heads the firm's tax group and advises on all manner of financial, corporate and real estate transactions. He acts for a wide range of domestic and international clients, including financial institutions, investment banks, arrangers, private equity groups, fund managers and administrators. Jonathan is an AITI Chartered Tax Adviser and a member of the Law Society of Ireland and the Dublin Solicitors Bar Association. He is also a member of the tax committees of the Irish Debt Securities Association and the International Tax Specialist Group in Irish Funds.

Damien Barnaville is a partner in the asset management and investment funds group at Walkers. He is an experienced financial services lawyer with a particular focus on advising on the establishment, authorisation, distribution and operation of all types of Irish investment funds, including UCITS and AIFs. Damien also advises asset managers, depositaries and fund administrators on their day-to-day regulatory obligations in Ireland.

Joe Mitchell is a senior associate in Walkers' asset management and investment funds practice. He is based in the Ireland office, where he manages the legal resources and know-how as well as advising on legal and regulatory developments in the industry.

Walkers

The Exchange
George's Dock
IFSC
Dublin 1
Ireland

Tel: +353 1470 6600
Fax: +353 1470 6601
Email: info@walkersglobal.com
Web: www.walkersglobal.com

1. Market Overview

1.1 State of the Market

The latest statistics published by the Central Bank of Ireland (Central Bank) show that the net asset value (NAV) of Irish-domiciled funds increased for the eighth successive quarter, driven by positive revaluations and transaction inflows, to EUR4.676 trillion at the end of the third quarter of 2024, representing a 21% increase (EUR822 billion) from EUR3.854 trillion at the end of Q3 2023. The number of Irish-domiciled funds (including sub-funds) grew from 8,870 at the end of 2023 to 8,993 at the end of August 2024.

In terms of the number of Irish-domiciled funds by category, Irish-domiciled alternative investment funds (AIFs) (including sub-funds) reached 3,434 at the end of August 2024, and the total number of Irish-domiciled undertakings for collective investment in transferable securities (UCITS) (including sub-funds) reached 5,559.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

AIFs that are domiciled in Ireland are predominantly established as regulated funds and are required to be authorised by the Central Bank. Regulated AIFs in Ireland are sub-divided into retail investor alternative investment funds (RIAIFs), qualifying investor alternative investment funds (QIAIFs) and European long-term investment funds (ELTIFs), with the vast majority of Ireland-domiciled AIFs being established as QIAIFs. The ELTIF can be authorised in Ireland as a standalone product and does not need to be established as a QIAIF or a RIAIF. It is also possible to have ELTIF and non-ELTIF sub-funds under the same umbrella, meaning an ELTIF sub-fund can be authorised on a QIAIF or RIAIF umbrella alongside a QIAIF or RIAIF sub-fund. As RIAIFs and Retail Investor ELTIFs are established and regulated as AIFs, they are included in this section (**2. Alternative Investment Funds**).

Five legal structures are currently available when establishing a regulated AIF in Ireland:

- investment company;
- Irish collective asset-management vehicle (ICAV);
- unit trust;
- common contractual fund (CCF); and
- investment limited partnership (ILP).

Separately, the 1907 LP is a long-standing Irish partnership structure vehicle established pursuant to the Limited Partnerships Act, 1907. The 1907 LP is not authorised by the Central Bank nor regulated by the Central Bank's AIF Rulebook and accordingly is outside the scope of this chapter.

Investment Company

Historically, the investment company was the vehicle of choice for investors looking for an Irish corporate fund vehicle. However, this changed in 2015 with the introduction of the ICAV as a bespoke corporate structure that caters specifically for the needs of the funds industry.

ICAV

The key advantages of the ICAV versus the investment company include:

- the ability to elect to dispense with the holding of an annual general meeting;
- the ability to file a "check the box" election to be treated as a partnership (or a disregarded

entity if a single shareholder) for US federal income tax purposes;
- the ability to amend the ICAV's constitutional document, known as the instrument of incorporation, without shareholder approval for certain types of changes;
- the ability to prepare separate financial statements for separate sub-funds of the ICAV; and
- not being required to make the audited financial statements publicly available.

Unit Trust

Investors seeking to use a trust structure for their investment fund can establish an AIF in Ireland structured as a unit trust. Unlike the investment company and the ICAV, which issue shares to their investors, unit trusts issue investors units representing a beneficial interest in the assets of the trust. As it is a trust arrangement, a unit trust is not a separate legal entity, meaning that it does not have power to enter into contracts in its own name. In practice, the board of directors of the fund manager acts on behalf of the unit trust.

CCF

While CCFs were initially developed in 2003 to facilitate the pooling of pension fund assets in a tax-efficient manner, this structure may be used by any entity seeking a tax-transparent structure; however, individuals cannot invest in CCFs. A CCF is a contractual arrangement constituted by a deed of constitution entered into between a management company and a depositary. Units in a CCF identify the proportion of the underlying investments of the CCF to which an investor is beneficially entitled.

Through contractual arrangements entered into with the management company, the investors participate and share in the property of the investment fund as co-owners of the assets of the fund. As a co-owner, each investor in the CCF holds an undivided co-ownership interest as a tenant in common with the other investors.

The CCF is a tax-transparent structure, which means that investors in a CCF are treated as if they directly own a proportionate share of the underlying investments of the CCF rather than shares, units or interests in an entity that itself owns the underlying investments.

ILP

The Investment Limited Partnerships (Amendment) Act 2020 amended the legislation governing ILPs, Ireland's regulated investment funds partnership product. These amendments enhanced the product offering by bringing it more in line with the partnership structures in other fund jurisdictions and introducing best-in-class features.

While partnership structures are generally used for investment funds with strategies relating to private equity or debt, real estate, infrastructure or other types of illiquid assets, the ILP is a flexible structure that can be utilised by asset managers seeking to establish either open-ended or closed-ended investment funds through a regulated partnership structure. An ILP can be structured as an umbrella fund, offering greater flexibility for those seeking to establish funds in Ireland. Investors in an ILP hold interests in the limited partnership by entering into a partnership agreement with the general partner as limited partners.

An Irish fund can be established as either a standalone fund or an umbrella fund comprising one or more sub-funds, each with segregated liability. Each sub-fund will generally have a different investment objective and policies, and may comprise different classes of shares/

units/interests. Typically, classes of shares/units/interests are issued to allow for different fee arrangements, different minimum subscription amounts, different currencies and/or different distribution arrangements within the same sub-fund. The legislative regime enables the assets and liabilities of each sub-fund of an umbrella investment fund established as an investment company, ICAV, unit trust, CCF or ILP to be segregated from the assets and liabilities of the other sub-funds of that umbrella, meaning that the liabilities of a sub-fund are discharged solely from the assets of that sub-fund. A sub-fund of an umbrella fund is not a separate legal entity, but an umbrella fund may sue and be sued in respect of a particular sub-fund.

General

QIAIF and RIAIFs can typically be structured as either open-ended, open-ended with limited liquidity or closed-ended. Open-ended QIAIFs provide redemption facilities on at least a quarterly basis. QIAIFs that offer redemption and/or settlement facilities on a less than quarterly basis or have the ability to implement a redemption settlement period of more than 90 days are categorised as open-ended with limited liquidity.

There are certain restrictions on the liquidity profile of Irish AIFs. For example, a loan-origination QIAIF must be closed-ended, and the Central Bank will only authorise property funds structured as (i) closed-ended or (ii) open-ended with limited liquidity, as per the Central Bank's AIF Rulebook.

ELTIFs are categorised as (i) closed-ended or (ii) open-ended with limited liquidity pursuant to Regulation (EU) 2015/760 as amended by (EU) 203/606 (the ELTIF Regulation).

Where an AIF is established as an investment company, it is required to spread investment risk. To meet this requirement, the RIAIF must comply with a series of investment and concentration limits in the AIF Rulebook, which are similar to those contained in UCITS legislation, albeit slightly less restrictive. The AIF Rulebook provides that a RIAIF may derogate from complying with certain investment restrictions for six months following the date of its launch, provided that it complies with the principle of risk spreading.

Master-feeder structures can be established for a variety of reasons, such as to cater for the different tax reporting requirements of certain categories of investors, including US taxable persons, non-US investors and US tax-exempt investors.

AIFs are increasingly established in Ireland to act as the master fund in master-feeder structures, which include an Irish feeder fund for European investors alongside feeder funds that are domiciled in other jurisdictions – eg, Delaware or the Cayman Islands. The use of an Irish master fund in the structure enables the passporting of the Irish master and/or Irish feeder fund throughout Europe using the Alternative Investment Fund Managers Directive (AIFMD) marketing passport.

The majority of investment managers and investment advisers appointed to act for Irish funds are domiciled in other jurisdictions, as the portfolio management activities are often performed outside of Ireland. However, the number of Irish-domiciled investment managers and investment advisers is on the rise, and such entities are generally structured as private companies limited by shares. It is also possible for the alternative investment fund manager (AIFM) to retain portfolio management responsibilities; this is a relatively common model, particularly for less active and/or less liquid portfolios. In such cases, the AIFM may establish an investment committee with input from an investment adviser.

2.1.2 Common Process for Setting Up Investment Funds

If an AIF is structured as an investment company or an ICAV, it will need to be incorporated or registered with the Irish Companies Registration Office or the Central Bank, respectively, prior to an application being submitted to the Central Bank for authorisation of the fund as a QIAIF.

With the exception of open-ended with limited liquidity ELTIFs and certain limited asset classes that require a pre-submission (namely QIAIFs proposing to invest in Irish property assets or seeking certain exposures to digital assets), a fast-track authorisation process is available, under which non-retail AIFs can be authorised by the Central Bank within 24 hours (by close of business on the day after submission of the application for authorisation) of filing the requisite documentation with the Central Bank. The prospectus, constitutional document and all material contracts being entered into in respect of such fast-tracked QIAIFs or ELTIFs must be submitted to the Central Bank as part of the application for authorisation of the fund. The Central Bank relies on confirmations from the fund's directors or manager (as relevant) and its Irish legal counsel that the fund complies with the relevant requirements of the Central Bank.

Prior to the submission of the application for fast-track authorisation of a QIAIF or an ELTIF, it is necessary to ensure that all service providers have received any requisite approvals from the Central Bank to act for Irish-domiciled funds. This is most relevant for discretionary investment managers that have not previously provided such services to Irish-domiciled funds. Further details of the clearance process for discretionary investment managers are set out in **2.3.3 Local Regulatory Requirements for Non-Local Managers**.

The timeframe for the establishment and authorisation of a QIAIF or ELTIF (not subject to any pre-submission requirements) generally ranges between six and 12 weeks, taking into account the various operational steps that need to be completed, such as the onboarding of service providers and the opening of various custody accounts, where required. Sub-funds of an existing umbrella structure can be established more quickly, depending on the circumstances.

2.1.3 Limited Liability

Investors in AIFs are generally only liable for any amounts outstanding on partly paid shares or, in a capital call structure, for any amounts committed but not yet called. The losses that an investor will suffer will be limited to the subscription or commitment amount.

In addition, umbrella funds have segregated liability between sub-funds, which means that the assets and liabilities of a sub-fund are ring-fenced and such assets cannot be used to satisfy the liabilities of another sub-fund.

2.1.4 Disclosure Requirements

Irish investment funds are required to provide investors with a prospectus disclosing key information about the investment strategy, the parties involved and the potential risks relevant to investing in the fund. AIFs are also required to provide a key information document (KID) to investors prior to accepting their investment in the fund, in accordance with the requirements of the amended Packaged Retail and Insurance-based Products (PRIIPs) Regulation, where those products are made available to investors in the EEA that are not classified as professional investors under MiFID.

Irish investment funds are also required to provide financial statements and an annual report on the financial state of the entity to investors. In contrast to the position applicable to an investment company, umbrella ICAVs may publish separate financial statements for each sub-fund.

The disclosure and reporting requirements set out in the AIFMD are applicable to Irish AIFs, including the disclosure requirements set out in Article 23 and the reporting requirements set out in Articles 3 and 24 (also known as Annex IV reporting). In addition, the ELTIF Regulation contains detailed disclosure requirements in accordance with the liquidity profile of the ELTIF, and additional disclosures and conditions are applied where an ELTIF is marketed to retail investors.

The Central Bank requires monthly and quarterly returns to be submitted, including details on the gross and net asset value, investor dealing activity, and fees and expenses accrued during the period. A new investment fund return was introduced by the Central Bank in December 2024, requiring dealing activity to be reported as at each dealing day of an in-scope Irish investment fund. Ad hoc regulatory reporting is also required in certain circumstances, such as the suspension of an investment fund, material breaches of the investment policy, or material errors in the calculation of the investment fund's NAV.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Investors in QIAIFs are not confined to any particular geographic region, and QIAIFs have also proved popular to investors outside of Europe, including in the Americas and Asia. QIAIFs can be used to invest in a wide range of asset classes and have proved particularly popular for a variety of hedge fund strategies, amongst others. The ELTIF is dedicated to facilitating long-term investments in liquid and illiquid assets by both professional and retail investors.

As investment in QIAIFs is limited to qualifying investors, a wide variety of institutional investors invest in such funds, such as pension schemes and insurance companies, together with private wealth investment comprising family offices and high net worth individuals.

The number of RIAIFs that have been established is relatively low, with either the UCITS, QIAIF and increasingly the ELTIF being the product of choice for investors, depending on the investment strategy and target investors.

2.2.2 Legal Structures Used by Fund Managers

Entities seeking authorisation as Irish AIFMs in accordance with the AIFMD are typically established as private companies limited by shares.

2.2.3 Restrictions on Investors

Investments in QIAIFs and in qualifying investor ELTIFs can only be made by qualifying investors, which are typically institutional investors or sophisticated high net worth individuals. A separate category of professional investor ELTIF is available solely for distribution to investors who meet the MiFID II "professional client" criteria (Professional Investors). Investors who do not meet the criteria applicable to Professional Investors constitute retail investors. Accordingly, as the definition of qualifying investors is broader than the criteria applicable to Professional Investors, ELTIFs established for qualifying investors may also be subject to the requirements in the

ELTIF Regulation applicable to ELTIFs marketed to retail investors.

QIAIFs and qualifying investor ELTIFs require a minimum subscription of EUR100,000, although exemptions can be granted to:

- the fund's manager or general partner;
- any entity providing investment management or advisory services to the fund; and
- a director or employee of any of the above, in certain circumstances.

There is no limit on the types of investors (whether retail, institutional or high net worth investors) that can invest in RIAIFs or in Retail Investor ELTIFs.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

The AIFMD was transposed in Ireland by the European Union (Alternative Investment Fund Managers) Regulations 2013, as amended (the "AIFM Regulations"), and is the key legislation governing AIFs in Ireland. It primarily regulates the AIFM as opposed to the AIF directly and is supplemented in Ireland by the Central Bank's AIF Rulebook, its guidance on the specific requirements relating to AIFs and a series of Q&As. The Central Bank is the regulatory body responsible for the initial authorisation and ongoing supervision of all Irish investment funds, whether alternative or retail investment funds.

The Central Bank does not set any investment, borrowing or leverage limits for QIAIFs, except for loan origination QIAIFs and QIAIFs proposing to invest over 50% of the portfolio in directly or indirectly held Irish property assets. The Central Bank has not "gold-plated" the Irish ELTIF regime and, as such, the only product-specific restrictions applicable to Irish ELTIFs are those set down in the ELTIF Regulation and its delegated acts.

To qualify as an ELTIF, a fund must invest in permitted investments and comply with the product rules prescribed in the ELTIF Regulation. and must also be subject to the requirements of the AIFM Regulations and the ELTIF chapter of the AIF Rulebook. Eligible investments for an ELTIF include debt instruments issued by a qualifying portfolio undertaking (QPU), loans granted by the ELTIF to a QPU, and other categories of assets such as equity or quasi-equity issued by a QPU, other European investment funds, real assets, certain simple, transparent and standard securitisations and European green bonds. UCITS eligible assets are also considered to be eligible liquid assets for ELTIFs.

In addition to the general rules applicable to QIAIFs contained in Part 1 of Chapter 2 of the AIF Rulebook, there are specific fund type requirements for money market QIAIFs, QIAIFs that invest more than 50% of their assets in another investment fund, closed-ended QIAIFs and loan origination QIAIFs. In addition, specific requirements are applied in respect of QIAIFs proposing to invest in Irish property assets or obtaining exposure to digital assets.

As a type of AIF, RIAIFs are subject to the requirements of the AIFM Regulations and the RIAIF chapter of the AIF Rulebook. The regulatory regime applicable to RIAIFs is more restrictive than that for QIAIFs, but less restrictive than the UCITS regime. For example, a RIAIF may invest no more than 20% of its assets in securities that are not traded in or dealt on a regulated market, and is precluded from investing more than 20% of its assets in any one issuer (the UCITS limit for both is 10%). RIAIFs are generally obliged to ensure that they are sufficiently diversified.

2.3.2 Requirements for Non-Local Service Providers

Whether alternative funds or retail funds, Irish investment funds must have an Irish-domiciled depositary and administrator, regulated and supervised by the Central Bank.

While Irish investment funds structured as investment companies and ICAVs may be self-managed, there has been a move towards funds that are externally managed by an AIFM, in the case of an AIF. A non-Irish AIFM based in the EU can manage Irish investment funds if it has made the requisite application to the competent authority in its home member state. Non-EU AIFMs can also manage Irish funds, subject to compliance with certain requirements. However, the AIFMD marketing passport is not available to non-EU AIFMs, and Irish AIFs with non-EU AIFMs may only be offered in Europe under the available national private placement regimes. ELTIFs are required to be managed by an EU AIFM, but the AIFM can delegate portfolio management to an investment manager outside of the EU.

A person must be approved by the Central Bank to act as a director of an Irish regulated entity or of a general partner of an ILP. The process involves submitting an individual questionnaire to the Central Bank for consideration. Directors and other individuals performing controlled functions, such as persons selected to act as designated persons for an AIFM, are required to comply with the requirements of the Central Bank's fitness and probity regime as well as the common and additional conduct standards introduced under the Individual Accountability Framework. If an investment fund is self-managed, the Central Bank's fund management companies guidance (FMC Guidance) will apply, which includes a broad range of governance requirements. Where the investment fund has appointed an external AIFM, the requirements of the FMC Guidance will apply to the AIFM, other than the section relating to externally managed funds.

Prime brokers may be appointed to provide services directly to an AIF and, provided that their services do not constitute discretionary portfolio management, which typically they would not, are not required to obtain any separate funds-related regulatory approval to provide these services to an Irish AIF. Irish investment funds are required to file any material contracts entered into by the fund with the Central Bank.

2.3.3 Local Regulatory Requirements for Non-Local Managers

The approval process for a discretionary investment manager depends on the entity's country of establishment. An Irish investment fund may typically only delegate investment management services to an entity that is authorised or registered for the purpose of asset management and subject to prudential supervision in its home jurisdiction. In addition, there must be supervisory co-operation between the Central Bank and the supervisory authority in the entity's home jurisdiction, which generally takes the form of a memorandum of understanding or a co-operation agreement between the jurisdictions. The Central Bank has accepted the following jurisdictions as having a comparable regulatory regime to Ireland: Abu Dhabi, Australia, the Bahamas, Bermuda, Brazil, Canada, Dubai, Guernsey, Hong Kong, India, Japan, Jersey, Malaysia, Qatar, Singapore, South Africa, South Korea, Switzerland, the United States and the United Kingdom.

A fast-track application is available to entities that are based in the EU and authorised as an investment firm under MiFID to provide portfolio management, and to externally appointed AIFMs, UCITS management companies or credit institutions authorised under Directive 2006/48/EC with approval to provide portfolio management under MiFID.

The fast-track application process is not available to non-EU entities, including UK-based entities. Non-EU-based entities must submit an application to the Central Bank prior to being appointed to act as a discretionary investment manager for Irish investment funds.

An entity cleared to act as an investment manager for Irish investment funds is required to notify the Central Bank in advance of a change of name, registered address or regulatory status.

2.3.4 Regulatory Approval Process

Please see **2.1.2 Common Process for Setting Up Investment Funds** for details of the applicable Central Bank fast-track processes for the authorisation of certain AIFs. This process also applies to the approval of new sub-funds of existing umbrella funds, and to amendments to the investment fund's documentation post-authorisation.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

The AIFM Regulations provide for pre-marketing in Ireland in accordance with the Cross-Border Distribution Directive ((EU) 2019/1160) (CBDD), whereby an EU AIFM or certain third parties on behalf of an EU AIFM can engage in the provision of information or communication, directly or indirectly, on investment strategies or investment ideas in order to test the interest of Professional Investors, provided that such activity does not amount to an offer or placement to the potential investor to invest in that AIF.

The transposing legislation in Ireland did not introduce any additional regulatory measures.

2.3.6 Rules Concerning Marketing of Alternative Funds

The marketing rules contained in the AIFMD apply to entities seeking to market AIFs in Ireland. The AIF Rulebook and other Central Bank guidance provide additional information on the marketing of AIFs to investors in Ireland. Further requirements have been introduced by the framework for the cross-border distribution of investment funds – consisting of the Cross-Border Distribution Regulation ((EU) 2019/1156) (CBDR) and the CBDD – including in relation to the pre-marketing to AIFs, marketing communications and local facilities arrangements. The firm carrying out the marketing activity will also need to consider whether it is performing any other regulatory activities that may need to be licensed under MiFID – eg, the provision of investment advice.

2.3.7 Marketing of Alternative Funds

In accordance with the AIFMD, authorised EU AIFMs are permitted to market Irish AIFs to professional investors in EU member states using the AIFMD marketing passport. There are currently no passporting rights available to non-EU AIFMs. However, marketing by non-EU AIFMs and registered EU AIFMs of Irish AIFs may be carried out under the national private placement regimes in EU member states, where those are available.

Marketing retail AIFs not domiciled in Ireland to retail investors in Ireland is permitted in limited circumstances, but an application must be submitted to the Central Bank before any marketing takes place.

ELTIFs can be marketed across the EU with a passport to both professional and retail investors, subject to the notification process in the AIFMD without being subject to additional national requirements. Additional safeguards are applied to the distribution and marketing of ELTIFs to retail investors.

The CBDR, in conjunction with ESMA's guidelines on marketing communication requirements, provides that all marketing communications addressed to investors should be identifiable as such and should describe the risks and rewards of purchasing units or shares of an AIF in an equally prominent manner. It also states that all information included in marketing communications needs to be fair, clear and not misleading.

Although RIAIFs may be marketed to retail investors in Ireland, they may only be marketed to professional investors in other EU member states using the AIFMD marketing passport. Certain EU member states may permit the marketing of AIFs to retail investors where additional steps are complied with, but this differs by jurisdiction on a case-by-case basis. RIAIFs must appoint a fully authorised AIFM, and non-EU managers or registered AIFMs are prevented from managing RIAIFs.

Aside from ELTIFs, which may avail of the cross-border marketing passport to retail investors, the marketing of retail AIFs not domiciled in Ireland is permitted in limited circumstances, but an application must be submitted to the Central Bank before any marketing takes place.

2.3.8 Marketing Authorisation/Notification Process

The marketing of EEA AIFs (including Irish AIFs) to professional investors (and also to retail investors in the case of an ELTIF) in Ireland benefits from the notification process to the AIFM's home state competent authority, as contemplated under the AIFMD and transposed into Irish law.

An Irish AIFM seeking to market an AIF authorised in the EEA should submit a notification to the Central Bank in accordance with Regulation 32 of the AIFM Regulations. A non-Irish EU AIFM seeking to market in Ireland a non-Irish AIF authorised in the EEA should submit a notification to its own competent authority. Upon the transmission of the notification file to the Central Bank, the AIFM may commence marketing in Ireland. An Irish AIFM or an AIFM authorised in another EEA member state seeking to market a non-EEA AIF in Ireland should submit a notification in accordance with Regulation 37 of the AIFM Regulations. A non-EEA AIFM seeking to market AIFs in Ireland should submit a notification in accordance with Regulation 43 of the AIFM Regulations.

The Central Bank does not impose additional requirements in relation to passported EEA AIFs other than those laid down in the AIFMD. The Central Bank does not impose local service provider requirements, such as a local representative and/or paying agent, nor does it levy any regulatory fees (either initial or ongoing) to avail of marketing rights under the passport.

2.3.9 Post-Marketing Ongoing Requirements

The AIFM must give written notice of a material change to any of the particulars communicated in the original passport notification to the competent authorities of its home member state at least one month before implementing a planned change or, where it is not possible to do so, immediately after such an unplanned change has occurred.

Similarly, a material change to the details of marketing in accordance with Regulation 43 of the AIFM Regulations should be notified by the non-EU AIFM to the Central Bank without delay.

In order to cease marketing a passported AIF in Ireland, a notification to de-register should be made to the competent authority of the AIFM's home member state. From the date of de-notification, a three-year "black-out" period is triggered, during which any pre-marketing of the relevant AIF or in respect of similar investment strategies or investment ideas is prohibited.

2.3.10 Investor Protection Rules

Qualifying investors can subscribe for shares, units or interests in a QIAIF and in a qualifying investor ELTIF, whereas only Professional Investors may invest in a professional investor ELTIF, as set out in **2.2.3 Restrictions on Investors**.

Any further restrictions on the types of eligible investors will be set out in the fund's prospectus.

Please see **2.1.4 Disclosure Requirements** for a summary of the regulatory reporting requirements applicable to QIAIFs and ELTIFs.

2.3.11 Approach of the Regulator

Under the fast-track process, applications for the authorisation of QIAIFs and ELTIFs, approvals of new sub-funds and post-authorisation amendments for existing QIAIFs or ELTIFs are processed within 24 hours of receipt, with the exception of submissions relating to open-ended with limited liquidity ELTIFs, retail investor ELTIFs and certain limited QIAIF asset classes (as detailed in **2.1.2 Common Process for Setting Up Investment Funds**), in which case a prior submission to the Central Bank is required.

The Central Bank is generally available to answer specific queries relating to the authorisation and ongoing supervision of AIFs. Such queries generally need to be submitted in writing to the Central Bank for consideration, and the timeframe within which the Central Bank will respond depends on the nature of the query received. The Central Bank will typically not address technical or complex queries on a "no names" basis. Face-to-face meetings are not typically required for the authorisation of AIFs.

2.4 Operational Requirements

Irish AIFs are required to appoint an Irish-based depositary that is responsible for the safekeeping of the fund's assets, and are subject to the full AIFMD depositary regime. However, an Irish-based depositary of assets other than financial instruments (DAoFI or a real asset depositary) may be appointed to act for a specific type of QIAIF (those funds that have no redemption rights exercisable for at least five years from the date of initial investment and that generally do not invest in financial instruments that can be held in custody). Any entity acting as a depositary or DAoFI for Irish investment funds is required to be authorised by the Central Bank to provide such services. There are also rules relating to the holding of investors' money in collection accounts and umbrella cash accounts.

Details of how an investment fund's assets are valued are required to be set out in the investment fund's constitutional document and should comply with the valuation rules set out in the AIF Rulebook. Unless an external valuer is appointed, the AIFM will retain responsibility for valuing the fund's assets. The administrator will assist in calculating the NAV of the fund but will not have any discretion in relation to how assets are valued and will adhere to the valuation policy adopted by the AIFM in respect of the fund.

Details of the potential risks relevant to the investment fund are required to be disclosed in the fund's prospectus.

Rules relating to insider trading, market abuse and transparency are generally only applicable to Irish listed investment funds.

As Irish regulated entities, Irish investment funds (whether AIFs or UCITS) are subject to anti-money laundering and counter-terrorism financing (AML/CFT) legislation. As they generally delegate transfer agency activities including investor services to an administrator, Irish investment funds need to be aware of the administrator's policy in relation to AML/CFT, in addition to having their own policy in place.

2.5 Fund Finance

There are generally no restrictions on AIFs entering into financing arrangements to fund the purchase of investments or for liquidity management purposes. In accordance with the AIFMD, AIFs are required to disclose their maximum level of leverage using both the gross method and the commitment approach.

Loan origination QIAIFs are restricted in terms of the amount that can be borrowed, as such funds must not have gross assets of more than 200% of their NAV. An ELTIF is restricted to borrowing no more than 100% of NAV for ELTIFs marketed solely to professional investors. This limit is reduced to 50% of NAV for ELTIFs that can be marketed to retail investors (which may include qualifying investors). RIAIFs are not permitted to borrow an amount exceeding 25% of the fund's NAV.

Lenders will typically take security as part of financing arrangements with AIFs, with the types taken depending on the purpose of the financing and the fund structure. For example, if financing is being obtained to fund investment, it is common for security to be granted over the assets of the investment fund, including any cash accounts held by the depositary on behalf of the fund. If the fund has a capital call structure, it is common for security to be granted over the capital commitment account(s) into which commitments are drawn, as well as over any uncalled commitments. Lenders would typically also have the right to call uncalled capital commitments.

QIAIFs are not permitted to act as a guarantor for third parties; this includes a sub-fund acting as guarantor for another sub-fund in the same umbrella. This restriction can create challenges in relation to the use of financing structures that require cross-collateralisation between borrowing entities falling within the same borrowing group. Depending on the structure, a cascading pledge mechanism can be used to overcome such challenges. The prohibition on acting as a guarantor for third parties does not apply to wholly owned subsidiaries of the QIAIF.

It is necessary to register a security interest with the relevant authority, which will be either the Irish Companies Registration Office or the Central Bank, depending on the structure of the investment fund.

2.6 Tax Regime

Irish investment funds structured as authorised investment companies, ICAVs and authorised unit trusts (both AIFs and retail funds) are subject to the Investment Undertaking Tax (IUT) regime and are exempt from Irish tax on their income and gains, assuming they do not invest in Irish real estate – see below with respect to the Irish real estate fund (IREF) regime. No stamp duty is payable on transfers of shares or units of an Irish investment fund (other than of an IREF in certain circumstances), and no subscription tax is payable on the issue of shares or units of an Irish investment fund.

If a declaration of non-Irish residence is provided to the fund, Irish tax is not payable on distributions or redemption payments to non-Irish resident investors in Irish funds. Distributions or redemption payments to certain classes of exempt Irish resident investors (eg, pension funds, charities and other Irish regulated funds) may also be paid by the fund free from Irish tax, provided a relevant declaration is in place.

The IUT Regime and Tax Transparent Funds

Where an investor is resident (or ordinarily resident) in Ireland for Irish tax purposes and is not an "exempt Irish investor", an Irish investment fund must deduct Irish tax on certain "chargeable events" (eg, distributions, redemptions and transfers) and on a "deemed disposal", which takes place eight years from the date of each acquisition of shares or units in an Irish fund, and each subsequent period of eight years thereafter.

Simplification measures to dispense with the IUT withholding obligation for the fund on a deemed disposal are available where the shares or units held by non-exempt Irish investors are worth less than 10% of the value of the total shares or units in the fund. Such investors must instead pay tax on the deemed disposal on a self-assessment basis. Irish tax at the rate of 41% must be deducted from all distributions and redemptions, and in respect of any gains arising by virtue of a transfer of shares or units in the fund held by Irish resident individuals who are not otherwise exempt. If the distribution, redemption or proceeds of transfer are paid to a company, the rate of withholding tax is 25%.

Irish investment funds structured as CCFs or ILPs are transparent for Irish tax purposes, and profits are treated as arising directly to investors. Investors in investment funds structured as CCFs may be able to claim double tax treaty relief at investor level in respect of the underlying investments of a CCF. Ireland has an extensive and growing network of double taxation treaties that provide, inter alia, access to favourable tax reclaim rates (comprehensive double taxation treaties are currently signed with 78 countries, of which 75 are in effect).

The Finance Act 2021 introduced ATAD-compliant reverse hybrid mismatch provisions into Irish law, which can apply to tax transparent funds such as CCFs or ILPs. The provisions apply in limited circumstances only and should only be relevant to Irish regulated funds that are considered transparent for Irish tax purposes, such as CCFs or ILPs.

As is the case with most EU member states and multiple jurisdictions globally, Ireland introduced new OECD Pillar Two rules for large multinationals; see **4.1 Recent Developments and Proposals for Reform**.

The IREF Regime

A further specific tax regime applies to Irish AIFs structured as ICAVs, investment companies or unit trusts that invest in Irish real estate (IREFs). Introduced in the Finance Act 2016, the IREF regime applies where 25% or more of the value of the assets of the investment fund (or of a sub-fund in the case of an umbrella fund) is made up of Irish real estate assets, or where it would be reasonable to consider that the main purpose or one of the main purposes of the fund is to acquire IREF assets or carry on an IREF business (ie, activities involving IREF assets, including dealing in or developing land or a property rental business).

Where the IREF rules apply, withholding tax ("IREF withholding tax") at the rate of 20% of the "IREF taxable amount" must be deducted from payments made to unitholders on an "IREF taxable event", such as a distribution or redemption, and on a sale of shares or units in the IREF. As the regime operates in parallel with the IUT regime, broadly, IREF withholding tax applies in relation to those investors that are exempt from IUT, such as non-Irish resident investors and certain classes of exempt Irish investor. However, certain of those investors are also exempt under the IREF regime. The categories of exempt persons are restricted broadly to widely held EEA/EU regulated pension funds, life assurance companies, other authorised funds and their EU/EEA equivalents, exempt charities, credit unions and companies benefitting from the Irish securitisation tax regime in Section 110 of the Taxes Consolidation Act 1997, as amended.

An investor in an EU member state (other than Ireland) or a country with which Ireland has a double tax treaty may reclaim IREF withholding tax under the dividends article of the relevant double tax treaty, and the Irish tax will be reduced to the treaty rate. However, beneficial owners of 10% or more of the shares or units in an IREF (directly or indirectly) are technically precluded from claiming treaty relief as the Irish rules treat the payment from the IREF to such persons as income from immovable property, to which the source country (Ireland) would typically be given taxing rights under a double tax treaty.

The Finance Act 2019 introduced further changes to the IREF regime, including anti-avoidance provisions that apply a 20% income tax charge at fund/sub-fund level to combat excessive debt and financing cost deductions, and non-IREF business-related expenses that can reduce the profits that would otherwise be subject to IREF withholding tax on distributions/redemption payments. The debt/financing cost restrictions comprise both a debt-to-cost threshold and a profit financing cost ratio, with financing costs in excess of the applicable ratios being treated as deemed income subject to income tax at 20%. Financing costs on genuine third-party debt are excluded from the provisions.

Stamp Duty

The transfer of units in an investment undertaking (such as an authorised ICAV or investment company), a CCF or an ILP is exempt from stamp duty, but it can apply in respect of the transfer of units in an IREF in certain circumstances.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

There are three types of Irish investment funds available to retail investors: RIAIFs, Retail Investor ELTIFs and UCITS.

Both RIAIFs and Retail Investor ELTIFs are AIFs, as detailed in **2.1.1 Fund Structures**, so are not re-considered in detail in this section (**3. Retail Funds**), which focuses on UCITS as the long-standing standard EU investment fund product available to both retail and institutional investors.

UCITS in Ireland can adopt any of the available fund structures, except the ILP. On a legislative basis, UCITS are required to operate on the principle of risk spreading, regardless of what legal structure is used.

UCITS are open-ended structures where dealing must, at a minimum, be offered twice a month at regular intervals. In practice, the majority of UCITS are structured as daily dealing funds.

As mentioned in **2.1.1 Fund Structures**, the majority of investment managers and investment advisers appointed to act for Irish investment funds are domiciled in other jurisdictions, but any such Irish incorporated entities are generally structured as private companies limited by shares.

3.1.2 Common Process for Setting Up Investment Funds

Where structured as an investment company or an ICAV, the fund will need to be incorporated or registered with the Irish Companies Registration Office or the Central Bank, respectively, prior to an application being submitted to the Central Bank.

Unlike an application for authorisation of a QIAIF, which can generally avail of the Central Bank's fast-track authorisation process (see **2.1.2 Common Process for Setting Up Investment Funds**), an application for authorisation of a UCITS (or an AIF available to retail investors) is subject to a detailed review of the investment fund's key documentation by the Central Bank. After its initial review of the draft documentation, the Central Bank will issue comments, which need to be dealt with before the investment fund can be authorised. All other material contracts entered into by the UCITS (or an AIF available to retail investors) will need to be submitted to the Central Bank on authorisation day, with corresponding certifications being made as to their compliance with the requirements of the Central Bank.

Before a UCITS or an AIF available to retail investors is approved by the Central Bank, it is necessary to ensure that all service providers have obtained any requisite pre-approvals from the Central Bank to act for Irish-domiciled investment funds. This is most relevant for discretionary investment managers that have not previously provided such services to Irish domiciled investment funds. Please see **2.3.3 Local Regulatory Requirements for Non-Local Managers** for further details of the clearance process for discretionary investment managers.

For applications for new UCITS or RIAIFs that are not clones of previously authorised funds, the Central Bank aims to respond to initial comments within 20 business days of receiving a complete application, and to respond to all subsequent comments within ten business days of receipt. The timeframe for the establishment and authorisation of UCITS and other retail investment funds generally ranges from 12 to 24 weeks.

3.1.3 Limited Liability

Investors in UCITS are generally only liable for any amounts subscribed for, so that any losses suffered by an investor will be limited to the subscription amount.

In addition, umbrella funds have segregated liability between sub-funds as a matter of Irish law, which means that the assets and liabilities of a sub-fund are ring-fenced and such assets cannot be used to satisfy the liabilities of another sub-fund.

3.1.4 Disclosure Requirements

As set out in **2.1.4 Disclosure Requirements**, Irish investment funds are required to provide investors with a prospectus that discloses key information about the investment strategy, the parties involved and the potential risks relevant to investing in the investment fund. Prior to accepting an investment in the fund, all UCITS must provide investors with either a PRIIPs KID or a key investor information document (KIID), which are short form offering documents summarising the key features of the UCITS.

The PRIIPs KID and the KIID are similar but have certain differences. Under legislative measures, UCITS are required to make an annual submission of KIIDs to the Central Bank (to the extent KIIDs continue to be produced), and to submit an annual report detailing the types of financial derivative instruments invested in by the fund during the period. Funds that are required to provide PRIIPs KIDs to EEA retail investors are required to submit the PRIIPs KIDs to the Central Bank.

Irish investment funds are also required to provide financial statements and an annual report on the financial state of the entity to investors. Umbrella ICAVs may publish separate financial statements for each sub-fund.

In addition, the Central Bank requires ad hoc regulatory reporting in certain circumstances, such as the suspension of a fund, material breaches of the investment policy, and if there are material errors in the calculation of the fund's NAV.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

Investment in Irish UCITS is not limited to retail investors: all types of institutional investors and high net worth individuals invest in UCITS, which are the most popular fund type in Ireland. According to figures published by the Central Bank, the total assets held by Irish UCITS at the end of November 2024 amounted to EUR4,027 trillion, an increase of EUR810 billion from the end of 2023, driven by transaction inflows and positive market movements.

3.2.2 Legal Structures Used by Fund Managers

UCITS management companies are typically established as private companies limited by shares.

3.2.3 Restrictions on Investors

There are no regulatory restrictions on the types of investors that can invest in Irish UCITS, provided they comply with on-boarding and anti-money laundering due diligence requirements.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

UCITS established in Ireland are authorised under the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 as amended (the "UCITS Regulations"), which transpose the UCITS Directive (2009/65/EC). The Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2019 (the "Central Bank UCITS Regulations"), together with the Central Bank's Q&As on UCITS and other guidance, provides information on the specific requirements relating to UCITS.

UCITS may invest in transferable securities and other liquid financial assets, but the following restrictions apply in terms of permitted investments:

- limits on the types of investments in which UCITS can invest;
- diversification limits;
- limits on the use of financial derivative instruments; and
- limited use of leverage.

For example, a UCITS may invest no more than 10% of its net assets in securities that are not listed, traded or dealt in on a regulated market, and is precluded from investing more than 10% of its assets in any one issuer, other than in the case of certain exempted categories of issuers where higher limits are applied. Where a UCITS invests more than 5% of its assets in any issuer, the maximum amount of any such holdings in excess of 5% is limited to 40% of the NAV of the investment fund (known as the 5/10/40 rule), other than in the case of certain exempted categories of issuers where higher limits are applied.

3.3.2 Requirements for Non-Local Service Providers

All Irish investment funds (whether AIFs or UCITS) must have an Irish-domiciled depositary and administrator, which are regulated and supervised by the Central Bank.

While Irish investment funds structured as investment companies and ICAVs may be self-managed, there has been a move towards funds that are externally managed by a UCITS management company, in the case of a UCITS. A non-Irish UCITS management company based in the EU can manage Irish investment funds if it has made the requisite application to its home regulator. In recent years, there has been a rise in so-called "Super ManCos", which are entities seeking authorisation from the Central Bank as both an AIFM and a UCITS management company in order to act for AIFs and UCITS.

A person must be approved by the Central Bank to act as a director of a UCITS, and is required to comply with the requirements of the Central Bank's fitness and probity regime as well as the common and additional conduct standards, as set out in **2.3.2 Requirements for Non-Local Service Providers**.

Irish investment funds are required to file any material contracts they enter into with the Central Bank.

3.3.3 Local Regulatory Requirements for Non-Local Managers

The approval process for a discretionary investment manager of a UCITS is the same as the process for AIFs, as set out in **2.3.3 Local Regulatory Requirements for Non-Local Managers**.

3.3.4 Regulatory Approval Process

As the Central Bank reviews key fund documentation as part of the application for authorisation of a UCITS (as well as retail investor AIFs), the timeframe for obtaining authorisation depends on the level of comment received from the Central Bank on the documentation submitted.

For applications for new UCITS or RIAIFs that are not clones of previously authorised funds, the Central Bank aims to respond to initial comments within 20 business days of receiving a complete application, and to respond to all subsequent comments within ten business days of receipt. This timeframe also applies to applications for the approval of new sub-funds that are considered to be complex.

Where it is intended to invest in contracts for difference (CFDs), collateralised loan obligations (CLOs), contingent convertible securities (CoCos), binary options or such other asset classes as the Central Bank may prescribe from time to time, the application will be subject to enhanced scrutiny by the Central Bank and additional information may be sought, including model portfolio information. For new sub-funds that are clones of previously approved sub-funds or are considered to be non-complex, the Central Bank aims to respond to initial comments within ten business days of receiving a complete application, and to respond to all subsequent comments within five business days of receipt.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

There is no pre-marketing regime available for UCITS, nor for AIFs pre-marketing to non-professional investors.

3.3.6 Rules Concerning Marketing of Retail Funds

The marketing rules contained in the UCITS Directive apply to entities seeking to market UCITS in Ireland. The Central Bank UCITS Regulations and other Central Bank guidance provide additional information on the marketing of UCITS to investors in Ireland. As set out in **2.3.6 Rules Concerning Marketing of Alternative Funds**, additional requirements have been introduced for the cross-border distribution of investment funds, including in relation to marketing communications and local facilities arrangements. A prior notification period of one month for certain changes, including the marketing of additional share classes, was also introduced in respect of UCITS. The firm carrying out the marketing activity will also need to consider whether it is performing any other regulatory activities that may need to be licensed under MiFID – eg, the provision of investment advice.

3.3.7 Marketing of Retail Funds

A UCITS can generally be sold without any material restriction to any category or number of investors in any EU member state, subject to the filing of appropriate documentation with the relevant competent authority in the EU member state(s) where it is intended to market the investment fund.

As set out in **2.3.7 Marketing of Alternative Funds**, the CBDR and ESMA's guidelines on marketing communication requirements apply rules in respect of the marketing communications of retail funds.

3.3.8 Marketing Authorisation/Notification Process

In order to market a UCITS in Ireland, a marketing application must be submitted to the competent authority in its home member state for onward submission to the Central Bank prior to the commencement of marketing in Ireland. The notification file is submitted electronically, consisting of a standard form notification letter and fund documentation. It is transmitted from the home state authority to the Central Bank, which will issue its confirmation, after which the notified class(es) of the UCITS may be marketed in Ireland.

The prospectus of a UCITS that is authorised in another member state and markets its units in Ireland must provide the following information for Irish investors:

- details of the facilities agent and of the facilities that are being maintained; and
- relevant provisions of Irish tax laws.

Ireland has implemented Article 43 of the AIFMD, which permits the marketing of AIFs to retail investors. Accordingly, it is possible for a non-Irish AIF to market in Ireland to retail investors.

An AIF situated in another jurisdiction that proposes to market its units in Ireland to retail investors must apply to the Central Bank in writing and may not conduct marketing in Ireland until it has received a letter of approval from the Central Bank. The Central Bank requires that such AIFs must be authorised by a supervisory authority to ensure the protection of unitholders; such protection must be equivalent to that provided under Irish laws, regulations and conditions governing Irish authorised RIAIFs.

The AIF shall include the following information for Irish retail investors in its prospectus:

- details of the facilities agent and the facilities maintained;
- provisions of Irish tax laws, if applicable; and
- details of the places where issue and repurchase prices can be obtained or are published.

When an AIF has received approval from the Central Bank to market units in Ireland to retail investors, the name of the AIF and the name and address of the facilities agent will be placed on a list of AIFs marketing in Ireland to retail investors, which will be made available to the public on request.

3.3.9 Post-Marketing Ongoing Requirements

Funds marketing their units to retail investors in Ireland must comply with the law, regulations and administrative provisions in force in Ireland, including but not limited to the Consumer Protection Code of the Central Bank.

UCITS and AIFs marketing in Ireland to retail investors must submit a copy of their annual and any half-yearly reports to the Central Bank, as soon as they are available.

UCITS availing of the marketing passport in Ireland must keep the key fund documents in the notification file up to date and must give one month's advance written notice to the host member state of any changes to be made to the classes that will be marketed in the host member state. Accordingly, changes in information in the original notification letter or a change in the share classes to be marketed should be submitted to the home and host state competent authorities at least one month before the implementation of the change.

UCITS must ensure compliance with the Central Bank UCITS Regulations regarding the contents, format and manner of presentation of marketing communications, including compulsory warnings and restrictions on the use of certain words or phrases and the advertising standards set out in Schedule 6 of the Central Bank UCITS Regulations.

A de-registration process (as detailed in **2.3.9 Post-Marketing Ongoing Requirements**) must also be followed where it is proposed that UCITS will cease cross-border marketing, pursuant to the marketing passport.

3.3.10 Investor Protection Rules

There are no Irish regulatory restrictions on the categories of investors that can invest in UCITS. Any restrictions on the categories of investors that a UCITS may be marketed to will be set out in the fund's prospectus.

Please see **3.1.4 Disclosure Requirements** for a summary of the regulatory reporting requirements applicable to UCITS.

3.3.11 Approach of the Regulator

The Central Bank is generally available to answer specific queries relating to the authorisation and ongoing supervision of UCITS. Such queries generally need to be submitted in writing to the Central Bank for consideration, and the timeframe within which the Central Bank will respond depends on the nature of the query. The Central Bank is reluctant to deal with substantive or complex queries on a "no names" basis.

Face-to-face meetings are not typically required in respect of the authorisation of UCITS, unless there is a particularly significant aspect of the project.

3.4 Operational Requirements

Retail investment funds in Ireland are limited in terms of not only the types of assets that can be invested in but also the exposure to particular securities and issuers. UCITS are permitted to invest in transferable securities and other liquid financial assets but are not permitted to invest directly in real estate or commodities, nor to engage in physical short selling.

Investments by UCITS in other open-ended collective investment schemes that are not established as UCITS are subject to additional requirements, including requirements relating to those underlying funds being subject to equivalent supervision and investor protection measures. Investment in closed-ended funds by UCITS is limited to circumstances where the underlying closed-ended funds meet the definition of a transferable security and fulfil certain corporate governance and regulatory requirements.

As detailed in **3.3.1 Regulatory Regime**, UCITS are subject to a more stringent regulatory regime than AIFs in terms of permitted investments and investment restrictions.

Whether established as AIFs or UCITS, Irish investment funds are required to appoint an Irish-based depositary that is responsible for the safekeeping of the fund's assets, which must be authorised by the Central Bank to provide such services. There are also rules relating to the holding of investors' money in collection accounts and umbrella cash accounts.

Details of how an investment fund's assets are valued need to be set out in the fund's constitutional document and should comply with the valuation rules set out in the UCITS Regulations or the AIF Rulebook, as relevant. Details of the potential risks relevant to the investment fund must be disclosed in the fund's prospectus. Rules relating to insider trading, market abuse and transparency are generally only applicable to Irish listed funds.

As Irish regulated entities, Irish investment funds (whether AIFs or UCITS) are subject to AML/CFT legislation. Because Irish investment funds generally delegate investor services activities to an administrator, such funds need to be aware of the administrator's policy in relation to AML/CFT, in addition to having their own policy in place.

3.5 Fund Finance

Retail investment funds in Ireland have limited borrowing powers. UCITS are only permitted to borrow up to 10% of the fund's NAV on a temporary basis. Typically, UCITS may use temporary borrowing facilities for short-term liquidity purposes – eg, to ensure the timely payment of redemptions, particularly where less liquid investments are being disposed of. As noted in **2.5 Fund Finance**, RIAIFs may borrow an amount equal to up to 25% of the fund's NAV; ELTIFs that can be marketed to retail investors can borrow an amount equal to up to 50% of the NAV of the ELTIF.

3.6 Tax Regime

The tax regime for retail investment funds in Ireland does not differ from that applicable to AIFs – see **2.6 Tax Regime**, although the IREF regime referred to therein does not apply to Irish retail investment funds regulated as UCITS funds.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

European Initiatives

A number of European initiatives will have an impact on Irish domiciled funds, particularly Directive (EU) 2024/927 (AIFMD II) and changes under consideration to the Sustainable Finance Disclosure Regulation (EU) 2019/2088 and the UCITS eligible assets regime, in addition to initiatives seeking to promote supervisory convergence at a European level, including in the areas of sustainable finance, the supervision of costs and fees and asset valuations. These initiatives are not considered in detail in this chapter as they are at a European level.

Fund Sector Review 2030

In October 2024, the Department of Finance (DoF) published its final report on the Fund Sector Review 2030, marking the culmination of its wide-ranging review of the investment funds sector in Ireland, under the themes of “Open Markets, Resilient Markets and Developing Markets”. The key objectives of the review include developing a framework within which Ireland can maintain its leading position in fund management and fund servicing, and ensuring that the sector continues to support economic activity at both regional and national levels in Ireland. The DoF was tasked with reviewing Ireland’s funds sector framework to ensure it is up-to-date and to take account of developments necessary to support the long-term growth of the sector.

The report is wide-ranging in nature and sets out 42 recommendations, outlining significant opportunities to enhance the investment landscape in Ireland’s funds sector, including the continued growth of areas such as private assets, ETFs and structured finance, as well as measures enabling greater retail investment in the sector.

Central Bank Publications

The Central Bank has recently published the following:

- a new ELTIF chapter of the AIF Rulebook and updated authorisation processes to facilitate the establishment of closed-ended ELTIFs and open-ended with limited liquidity ELTIFs;
- the introduction of a macroprudential policy framework for Irish-authorised GBP-denominated liability-driven investment (LDI) funds;
- UCITS Q&A enabling ETF naming at a share class level;
- an industry letter following its thematic review of Irish authorised ETFs;
- updated notification and de-notification letters for cross-border activities under the AIFMD and the UCITS Directive;
- an industry letter following ESMA’s Common Supervisory Action with its findings on asset valuation;
- a streamlined filing process to facilitate the implementation of the ESMA Guidelines on funds’ names using ESG or sustainability-related terms; and
- a “Dear CEO” letter on marketing communications to retail clients.

Pillar Two Legislation

Ireland introduced new OECD Pillar Two rules, including a 15% global minimum corporate tax rate for large multinationals for accounting periods commencing on or after 31 December 2023 in Finance (No.2) Act 2023. The rules apply to members of groups that have annual consolidated revenues of at least EUR750 million; standalone non-consolidated entities with annual revenues of at least EUR750 million are also in scope.

Irish regulated funds are excluded from a domestic top-up tax that can be imposed under the rules. An exclusion from top-up taxes is also available under an income inclusion rule and an undertaxed profits rule for Irish regulated funds that are "investment entities" (as defined). In practice, most Irish regulated funds and entities within investment fund structures should fall outside the scope of the rules. There is no exclusion applicable to investment management entities, which need to be assessed based on the relevant facts and circumstances. Each structure should be assessed on a case-by-case basis to determine the potential impact, if any, of these rules.

Outbound Payments Defensive Measures

Legislation was included in Finance (No.2) Act 2023 to apply new tax defensive measures to certain outbound payments of interest, royalties and distributions (including dividends) towards jurisdictions on the EU list of non-cooperative jurisdictions (the "EU Blacklist") and no-tax and zero-tax jurisdictions. In short, the measures can disapply existing withholding tax exemptions on certain payments of interest, royalties and dividends by an Irish company to an "associated entity" located in a relevant jurisdiction.

The provisions apply to payments made on or after 1 April 2024. However, grandfathering applies in the case of existing arrangements in place on or before 19 October 2023, such that the provisions only apply to payments made on or after 1 January 2025 under such arrangements. The measures do not apply to the long-standing withholding tax exemption that applies to distributions and redemption payments made by regulated funds to non-resident investors, which remains in place. The measures do not affect the vast majority of Irish funds but they may be relevant for debt financing of regulated Irish funds by associated entities in no-tax and zero-tax jurisdictions.

Participation Exemption

The Finance Act 2024 introduced a participation exemption, which is available for distributions of foreign dividends received on or after 1 January 2025 from subsidiaries in EU/EEA and Irish treaty partner source jurisdictions. The participation exemption, where applicable, exempts in-scope dividends from corporation tax in Ireland and may be relevant for entities within investment fund structures, but would not directly impact Irish regulated funds as they are exempt from Irish corporation tax. The participation exemption is optional and, where an election is made, the exemption applies to all in-scope dividends for an accounting period. Existing "tax and credit" provisions to provide relief from Irish tax for foreign withholding tax deducted remain in place, as does an existing relief for portfolio investors.

The DoF announced that it will give further consideration to the geographic scope of the participation exemption during 2025. As such, it is possible that the geographic scope of the participation exemption may be expanded.

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Law and Practice

Contributed by:
Emidio Cacciapuoti, Giorgio Bobba and Davide Massiglia
ADVANT Nctm

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ADVANT Nctm Studio Legale's investment funds practice in Italy offers expertise in legal, regulatory and tax matters. The firm advises clients that are active in all sections of the funds market, including private equity, real estate, venture capital, debt, infrastructure funds, credit funds and funds of funds. Its lawyers provide assistance on fund formation for sponsors/managers, fund reviews for investors, on carried interest schemes, incentive schemes and co-investment plan structuring, reorganisations and spin-outs, secondary transactions, private equity house mergers, fund governance, transaction structuring and fund-level finance arrangements, including investor calls, equity bridge, co-investment and warehousing facilities. The team has unrivalled experience in the Italian market, having assisted a number of general partners acting in different sectors on their most recent fundraising and structuring initiatives.

Authors

Emidio Cacciapuoti is a partner at ADVANT Nctm Studio Legale, and focuses on the tax and regulatory aspects of funds, alternative investment fund structures and carried interest schemes. He obtained his LLM cum laude in International Taxation from Leiden University, and is a member of the Tax and Legal Committee of AIFI and the International Tax Working Group of Invest Europe. He serves as a member of the board of directors of Italian AIFMs. He co-authored the chapter on "Fund structuring in Italy" in "Global Tax Considerations in Private Fund Formation" (Private Equity International, 2016) and is the author of the AIFI book on "Fundraising in Private Equity – Terms and conditions" (Egea, 2016).

Giorgio Bobba is a counsel at ADVANT Nctm Studio Legale, and focuses his practice on banking and finance, particularly on advising corporate and commercial enterprises on the regulations governing financial intermediaries and the financial markets. He has developed specific knowledge of financial derivatives and ISDA transactions, and has a wealth of experience in private equity and venture capital transactions, project finance, investment in primary and secondary markets, market abuse and tender offers. He is admitted to the Milan Bar and serves as a member of the board of directors and as company secretary of Italian AIFMs and financial intermediaries.

Davide Massiglia is a counsel at ADVANT Nctm Studio Legale, and works primarily on investment funds, international taxation, corporate income taxation, M&A, Italian and international tax planning for high net worth individuals and taxation of real estate investments. He regularly advises managers and investors on fund formation and structuring, carried interest and transaction structuring, including financings. He graduated cum laude from Genoa University, and is a member of the International Fiscal Association. He serves as a member of the board of directors and as statutory auditor of Italian AIFs and financial intermediaries. He co-authored the chapter on "Fund structuring in Italy" in "Global Tax Considerations in Private Fund Formation" (Private Equity International, 2016).

ADVANT Nctm Studio Legale

Via Agnello 12
20121 Milan
Italy

Tel: +39 0272 5511
Fax: +39 027 255 1501
Email: bd@advant-nctm.com
Web: www. advant-nctm.com

ADVANT Nctm

Contributed by: Emidio Cacciapuoti, Giorgio Bobba and Davide Massiglia, **ADVANT Nctm**

1. Market Overview

1.1 State of the Market

The Italian investment funds market has largely overcome the challenges posed by the COVID-19 pandemic, returning to a stable and growth-oriented trajectory. ESG-driven strategies remain a cornerstone of the market, with private equity and venture capital funds maintaining a strong focus on sustainable projects. The state-owned investment arm, Cassa Depositi e Prestiti (CDP), remains a key player, leveraging the country's savings to support initiatives in renewable energy, digital transformation, and social impact ventures by acting as a limited partner in various AIFMs.

Retail investor demand for ESG-focused UCITS also remains robust, reflecting the market's steady commitment to sustainability. This consistent focus, combined with regulatory support, reinforces Italy's position as a reliable and attractive jurisdiction for responsible investment strategies.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

From a legal standpoint, alternative investment funds (AIFs) may be established in one of two different forms, as follows.

- A contractual form (*fondo chiuso*) that is set up by an AIFM, whose constitutional document is represented exclusively by the management rules of the AIF. A *fondo chiuso* is a contractual arrangement with no legal personality, set up by way of simple resolution of the AIFM's board of directors approving the relevant management rules – no further formalities or authorisation processes are required.
- A corporate form (*società di investimento a capitale fisso* (SICAF) – ie, a joint stock company with fixed capital) that is established in front of a public notary and whose constitutional documents are represented by the company by-laws and the investment agreement between the company, the manager (where external) and the investors. SICAFs, in turn, may differ between an internally managed SICAF, in which the functions of the AIFM are carried out by the SICAF itself (so it must be authorised as an AIFM and an AIF at the same time), and an externally managed SICAF, where management of the AIF is delegated to an external AIFM (in this case, there is no need for authorisation of the SICAF). A sub-species of SICAF has recently been introduced, the *società di investimento semplice* (SIS), which is aimed at facilitating investments in SMEs. It is to be established in the form of a SICAF that will internally manage the funds raised among its investors (in the same way as the internally managed SICAF). From a regulatory point of view, a SIS is defined as an AIF, and represents a lighter form of the traditional SICAF, with a lighter authorisation process, lighter regulatory burden and lighter governance (according to the draft of supervisory guidelines jointly issued by the Bank of Italy and CONSOB). In order to avail itself of this lighter regime, a SIS is subject to the following limitations (which do not apply to a traditional SICAF):
  - (a) assets under management must not exceed EUR50 million;
  - (b) company by-laws must specifically state that the corporate object of a SIS is the direct investment of its assets in small to medium-sized enterprises that are not listed on regulated markets and that are

in the activity testing (seed financing), establishing (start-up financing) or starting (early-stage financing) phase;
(c) no financial leverage is admitted; and
(d) share capital must be equal to at least EUR50,000.

Finally, it should be highlighted that, in order to avoid evading the law, individuals who are directly or indirectly promoting a SIS are subject to the EUR50 million limit mentioned above, which means that they have the right to establish – as promoters – more than one SIS (each addressed to a specific market sector), provided that the assets of each SIS are cumulatively calculated in order to verify the limit.

A *fondo chiuso* represents the lightest form of those mentioned above, with the fewest constraints. The relevant establishment is set up simply by resolution of the board of directors of the AIFM; except for the various outsourcers of the *fondo chiuso* (ie, depository, fund administrator and audit firm), no administrative bodies other than those of the AIFM are required. No authorisation from the competent supervisory authorities is required for establishment, and no checks on the requirements of the relevant investors are carried out.

A SICAF, on the other hand, requires the typical administrative bodies of a joint stock company (*società per azioni*), such as statutory auditors and a board of directors, in addition to the various outsourcers of the AIF. Being an AIF, an internally managed SICAF is seen as a single legal vehicle, so any subsequent SICAF must obtain authorisation from the competent supervisory authorities. Investors holding a stake equal to at least 10% of the share capital and corporate representatives of internally managed SICAFs must comply with honourability and professional competence requirements. Following Law No 21 of 5 March 2024, which amended the Consolidated Law on Finance (TUF), SICAFs externally managed by an authorised AIFM (*eterogestite*) are no longer required to be authorised by the supervisory authorities or meet the honourability and professional competence requirements for their shareholders or corporate representatives. Internally managed SICAFs (*autogestite*), instead, remain subject to full authorisation as both an AIF and an AIFM, including compliance with these requirements.

A SICAF is subject to the provisions of the Italian Civil Code governing joint stock companies, unless expressly provided for otherwise (for example, a prohibition on issuing bonds).

Participants' interests in a *fondo chiuso* are represented by units. Certificates representing the units are usually registered (*nominativi*) and are issued for whole numbers. The certificates can be split, provided that each certificate represents at least one unit. The AIFM is responsible for drafting such certificates, which indicate the relevant class of units subscribed. As requested by the AIFM, the certificates should be confirmed by the AIF's depositary.

Participants' interests in a SICAF are represented by shares, and are subject to the provisions of the Italian Civil Code that apply to joint stock companies.

Investments by investment managers and/or investment advisers of an AIF can be carried out either directly by the relevant person by subscribing the unit/share, or indirectly through a special purpose vehicle, which is usually structured either in the form of a limited liability company (*società a responsabilità limitata*) or through a simple partnership (*società semplice*).

2.1.2 Common Process for Setting Up Investment Funds

Fondo Chiuso

No pre-approval or authorisation is required to establish a *fondo chiuso* (except for the authorisation provided by the applicable EU regulations related to certain specific sub-categories of AIFs, such as European long-term investment funds, or ELTIFs). Once established, the *fondo chiuso* must be registered with the competent register held by the Bank of Italy, and given an International Securities Identification Number (ISIN) code. The requisite documentation is represented by the relevant management rules, containing the terms and conditions regulating the AIF and the participation of the investor in the AIF. The set-up of a *fondo chiuso* requires a resolution of the board of directors of the relevant AIFM, approving the management rules of the AIF; in this sense, the establishment process does not involve any particular costs, except for the costs related to the drafting of the management rules.

SICAF

Internally managed SICAFs (*autogestite*) must still be authorised by the Bank of Italy (with a positive opinion from CONSOB) and registered with the competent register. However, the March 2024 reform has removed the requirement for externally managed SICAFs (*eterogestite*) to obtain specific authorisation, and their shareholders or corporate representatives are no longer subject to honourability and professional competence requirements. All SICAFs must still obtain an ISIN code for their operations. In addition to the constitutional documents of the AIF itself (company by-laws and investment agreement), a series of documents must be filed with the Bank of Italy to obtain authorisation for an internally managed SICAF, such as:

- documentation proving the honourability and financial stability of the founding shareholders of the SICAF;
- documentation regarding the honourability and professional requirements of the members of the board of directors and statutory auditors of the SICAF;
- documentation in relation to the organisational structure; and
- a programme of activities.

The authorisation process for internally managed SICAFs (*autogestite*) is supposed to last between five and seven months, and is more expensive than for the establishment of a *fondo chiuso*. For externally managed SICAFs (*eterogestite*), the March 2024 reform has significantly simplified the regulatory framework, aligning it with the process applicable to the establishment of closed-end funds, thereby reducing both associated costs and administrative burdens.

2.1.3 Limited Liability

Pursuant to the applicable laws, the liability of each investor of an AIF is limited to the total amount of the units/shares subscribed by said investor (provided that certain amounts distributed to the subscribers can be re-called by the AIFM pursuant to the management rules/investment agreement of the AIF). The investors are not deemed to participate in the management of the business of the AIF, nor to become liable as a manager or otherwise for the debts and liabilities of the AIF solely by reason of the exercise of the rights and powers granted to them under the constitutional documents of the AIF, or, eventually, by acting (or appointing a representative to act) as a member of the relevant advisory board.

2.1.4 Disclosure Requirements

The AIFM must maintain the following records and books of account of the AIF/SICAF:

- the daily transaction book (*libro giornale*) of the AIF, recording the day-to-day activities related to the management, operation, and issuance and redemption of the units/shares;
- the AIF's yearly report (*relazione annuale*), along with a directors' report, to be audited by the audit firm (and, with respect to a SICAF, the annual financial statements);
- the semi-annual report (*relazione semestrale*) relating to the AIF's management during the first six months of any accounting period; and
- a prospectus with an indication of the value of the units/shares and the total value of the AIF in each case of issuance or reimbursement of the relevant units.

Specific reporting requirements are due for each AIF on a semi-annual basis, and include the financial data of the AIF, the composition of the portfolio, the units/shares recap and the value of the units/shares.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Investors in AIFs range from financial institutional investors (such as banks, insurance companies and funds of funds) to pension funds, family offices, big corporations willing to diversify their invested assets and, in a smaller percentage, (ultra) high net worth individuals.

2.2.2 Legal Structures Used by Fund Managers

According to the applicable regulations, the only legal structure that can be authorised as an AIFM is the joint stock company (*società per azioni*). In cases where particular types of investors require the establishment of corporate vehicles, already existing AIFMs establish externally managed SICAFs, while internally managed SICAFs are typically used by promoters/sponsors that are foreign, or not linked to AIFMs.

2.2.3 Restrictions on Investors

On 30 March 2022, a significant amendment to Italian legislation (Ministerial Decree No 30 of 5 March 2015) entered into force regarding those people (other than professional investors) who are allowed to subscribe units of a reserved AIF. Before the amendment, units of an Italian or EU reserved AIF could be marketed in Italy to, and subscribed by:

- professional investors;
- retail clients with a minimum commitment of EUR500,000; and
- directors (ie, members of the board of directors) and employees of the AIFM managing the AIF (with no minimum commitment).

The new legislation enlarges the group of people who can subscribe units of a reserved AIF, including into two additional categories:

- non-professional investors who, as part of the provision of investment advisory services, subscribe to or purchase units or shares of the AIF for an initial amount of not less than EUR100,000, provided that, as a result of the subscription or purchase, the total amount of investments in reserved AIFs does not exceed 10% of their financial portfolio (defined as the total value of the portfolio consisting of bank deposits, insurance investment products and financial instruments also available from other intermediaries or managers); and
- entities qualified to provide portfolio management services who, in the course of providing said services, subscribe to or purchase units or shares of the AIF for an initial amount of not less than EUR100,000 on behalf of non-professional investors.

In addition, the new legislation replaces the concept of "employee" (as a category which may subscribe units of a reserved AIF with no minimum commitment) with the concept of "personnel", which is defined as "employees and those who in any case operate on the basis of relationships that determine their inclusion in the company organisation, even in a form other than a subordinate working relationship".

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Reserved closed-ended AIFs are not subject to any investment limitations, except for the maximum amount of employable financial leverage (as calculated according to EU Delegated Regulation 231/2013) applicable to those funds that are allowed to provide finance to third parties using the funds' assets (so-called credit funds) equal to 1.5 (provided that such AIFs may be granted financing only by banks and authorised financial intermediaries).

Non-reserved open-ended AIFs are subject to the investment limitations provided with respect to UCITS funds.

Non-reserved closed-ended AIFs are subject to certain investment limitations, such as prohibitions on selling short financial instruments, investing in financial instruments issued by the AIFM managing the fund, and investing in assets directly or indirectly transferred or conferred by a shareholder holding qualified shareholdings, as well as by a director, general manager or statutory auditor of the AIFM. In addition:

- investment in unlisted financial instruments of the same issuer and in parts of the same undertaking for collective investment must not exceed 20% of the total assets of the fund;
- investment in a single real estate asset must not exceed 20% of the total assets of the fund; and
- investment in credits versus a single counterparty must not exceed 10% of the total assets of the fund.

2.3.2 Requirements for Non-Local Service Providers

Non-local service providers are not subject to regulation/registration requirements to the extent that they do not carry out an activity that is subject to the authorisation of the competent supervisory authorities. By way of example, and with no limitation, a service provider willing to provide services related to the compliance function or anti-money laundering is not subject to any specific requirement, while a custodian (in order to be appointed as custodian to an Italian AIF) or a risk manager (in order to be appointed as risk manager to an Italian AIFM) is subject to the applicable regulation and will be regulated and subject to supervisory activity in its home country.

2.3.3 Local Regulatory Requirements for Non-Local Managers

A distinction is drawn between a non-local manager managing AIFs in Italy through the establishment of a branch (*sede secondaria*) and a non-local manager managing AIFs in Italy under the freedom to provide services regime.

In the first option, the branch must comply with the regulatory provisions applicable to Italian AIFMs when dealing with investors and aimed at safeguarding investors' interests (including provisions on conflicts of interest), and must comply with a series of reporting/disclosure duties with the Italian supervisory authorities, such as submitting an annual report on how the relevant activity has been carried out, the annual report of the compliance officer, and the data on any complaints received.

Under the freedom to provide services regime, the activity of a non-local AIFM will continue to be supervised by the home country authority in accordance with the "home country control principle".

2.3.4 Regulatory Approval Process

Retail funds – other than reserved funds (which are not subject to any approval process) – are subject to the regulatory approval of the Bank of Italy, which must approve the relevant management rules. The request for authorisation is presented to the Bank of Italy by the AIFM and must include the text of the management rules, the confirmation by the depositary of being fully licensed, and the resolution of the board of directors. The fund is approved 60 days after the filing has been completed, provided that all the requested documentation has been submitted.

If the management rules of retail are drafted according to the standard format provided by the Regulations on Collective Asset Management adopted by the Bank of Italy on 19 January 2015, then the approval of the Bank of Italy need not be requested, provided that the board of directors of the AIFM acknowledges the presence of the conditions enabling it to avoid the approval of the Bank of Italy (in this case, a communication should be sent by the AIFM to the Bank of Italy within ten days of the approval of the management rules, attaching the management rules and the resolution of the board of directors). The Bank of Italy can forbid the establishment of the fund if there are issues connected with the financial and economic situation of the AIFM.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

The Italian legislative definition of "pre-marketing" of reserved AIFs (see Article 42-bis of the UFA) is directly borrowed from that included in the AIFM Directive and relates to the "provision of information or communications, whether directly or indirectly, on investment strategies or ideas by an asset management company, or on behalf thereof, to resident prospective professional investors or those with head office in the EU, in order to survey their interests in an Italian or EU AIF yet to be instituted, or instituted and for which the relevant notification procedure is yet to be activated in the member state in which the prospective investors are resident or have their head office."

No pre-marketing activity is admissible towards retail investors.

No pre-marketing activity is allowed in cases where the information provided to the prospective investors:

- is sufficient to allow the investors to commit to subscribing shares or units of a particular AIF;
- is equivalent to subscription forms or similar documents, in draft or final form; and
- is equivalent to the final version of the instrument of incorporation, prospectus or other document related to a yet-to-be-instituted AIF.

Where resident prospective professional investors are given (by the relevant AIFM) a draft prospectus or draft offering document, these must contain sufficient information for the investors to make investment decisions and clearly state that:

- they do not constitute an offering or invitation to subscribe shares or units of an AIF; and
- the information included therein is not complete and could be subject to change, and therefore investors should not rely on it.

From a procedural standpoint, the AIFM must send a pre-marketing notification to CONSOB within 14 days from the pre-marketing start date, and such notification must contain:

- a list of the member states, including possibly Italy, in which pre-marketing is taking or has taken place;
- the period of time during which pre-marketing is taking or has taken place;
- a brief description of the activity carried out within the context of pre-marketing, including the information on the presented investment strategies; and
- where relevant, a list of AIFs or sub-funds that are or have been the subject matter of pre-marketing.

It is worth noting that any subscription of units or shares of AIFs made by professional investors within 18 months from the pre-marketing start date indicated by the AIFM in the above-mentioned notification will be considered the result of the pre-marketing activities, if the object of said subscriptions are the units or shares of the AIF indicated in the information provided within the context of the pre-marketing activities, or of the AIF established as a result of said activities.

Pre-marketing activities on behalf of an AIFM can only be carried out by the following third parties:

- investment companies authorised under Directive 2014/65/EU;
- banks authorised under Directive 2013/36/EU;
- management companies of UCITS authorised under Directive 2009/65/EC;
- Italian asset management companies and EU AIFMs authorised under Directive 2011/61/EU; and
- entities acting as tied agents pursuant to Directive 2014/65/EU.

The above-mentioned provisions on pre-marketing do not apply to sub-threshold Italian AIFMs.

2.3.6 Rules Concerning Marketing of Alternative Funds

Please see earlier in **2.3 Regulatory Environment**.

2.3.7 Marketing of Alternative Funds

Please see **2.2.3 Restrictions on Investors**.

2.3.8 Marketing Authorisation/Notification Process

Italian AIFMs willing to market a reserved AIF (either Italian or EU) must submit advance notification to CONSOB, and can start marketing once the relevant no-objection communication has been issued by the competent authority. The notification must include the rules governing the AIF, the offering document, and information requested by Article 43 of the UFA, such as the identity of the custodian, the description of the AIF (including information on the term of the AIF, the investment policy, the level of fees and whether the AIF accumulates or distributes the proceeds) and the other documentation listed under Annex III or IV of the AIFMD, as applicable.

In addition, the potential target market (positive and negative) must be identified in advance and disclosed to the competent authority. The process takes around 60 days. This regime is not applicable to sub-threshold Italian AIFMs. Retail clients subscribing to units/shares of a reserved AIF should be given the key investor document (KID), pursuant to the PRIIPs regulations, by the AIFM before the relevant subscription.

The marketing of an AIF by an EU AIFM is subject to the provisions of the relevant member state, and the marketing of the relevant units/shares should be preceded by a communication from the member state's supervisory authority to CONSOB.

2.3.9 Post-Marketing Ongoing Requirements

For relevant modifications to the information and documents provided to CONSOB in the notification of the marketing of AIFs described in **2.3.8 Marketing Authorisation/Notification Process**, the AIFM must communicate the modifications to CONSOB at least 30 days before entry into force or, in the case of modifications which cannot be planned in advance, as soon as they are issued. CONSOB immediately transmits to the Bank of Italy the information contained in the notification and the documents attached. Within 15 business days of receiving the communication, CONSOB and the Bank of Italy may, within the scope of their respective competence, ban the modification.

2.3.10 Investor Protection Rules

Except for the marketing restrictions indicated earlier in **2.3 Regulatory Environment**, no further restrictions apply to investors, depending on the type of AIF. Certain internal regulatory requirements might apply to certain investors whose activity is, in turn, regulated and subject to supervision by the competent authorities (such as banks, insurance companies and pension funds).

2.3.11 Approach of the Regulator

In the last few years, the attitude of the Italian regulators (the Bank of Italy and CONSOB) has been moving towards a bespoke approach, whereby AIFMs are encouraged to reasonably direct any questions to the relevant authority in order to clear up any issues or doubts while interpreting a specific regulation. It is very common for each AIFM to have a dedicated individual within the authority for ordinary matters; recurrent face-to-face meetings (usually on a yearly basis) are encouraged by the Bank of Italy to update on current activity and present any further initiatives.

2.4 Operational Requirements

Applicable regulations impose on each AIFM the obligation to appoint a single custodian for the assets of each managed AIF. The role of custodian may be carried out by regulated entities only, such as Italian banks, Italian branches of foreign banks, Italian investment firms and Italian branches of foreign investment firms.

The depositary performs the custodian duties of financial instruments in its custody, and verifies the property and the registration of other assets. The depositary also holds the liquid assets of the AIF. In the performance of its duties, the depositary:

- verifies the legitimacy of the disposal, issuance, repurchase, reimbursement and annulment of the units/shares of the fund, as well as the distribution of the proceeds to investors;
- verifies the accuracy of the calculation of the value of the units/shares;
- verifies, in operations relative to the fund, that the counter-obligation is fulfilled within the established terms;

- carries out the instructions of the AIFM, unless they conflict with Italian law, the management rules of the AIF or the prescriptions of the supervisory authorities; and
- if the liquidity is not deposited with the depositary, monitors the liquidity flows of the fund.

The depositary is responsible to the AIFM and the AIF's investors for any prejudice they may suffer as a consequence of the breach of its obligations. In the event of loss of financial instruments in custody, unless the depositary can prove that the default was caused by accident or by force majeure, it must be held to return, without undue delay, financial instruments of the same kind or a sum for a corresponding amount, and will be held liable for any other loss suffered by the AIF or the investors due to failure to respect its obligations, whether intentional or due to negligence. In such cases, the provisions of Articles 100 and 101 of EU Regulation 231/2013 will apply.

Activities related to the valuation of the AIF's assets may be carried out internally (by an independent person in the case of a fully licensed AIFM – ie, someone not involved in any management activity of the AIF's assets) or externally by a service provider, pursuant to the principles established by EU Regulation 231/2013 and the Regulations on collective asset management adopted by the Bank of Italy on 19 January 2015.

The valuation policies and procedures adopted by the AIFM are subject to review at least annually. Within the valuation process, specific controls and checks are carried out by the internal control functions with respect to their respective areas of competence. The net asset value of the AIF is equal to the current value at the reference date of the valuation of the assets of which they consist, net of any liabilities. Investors have the right to obtain a copy of the document setting out the valuation criteria from the AIFM, free of charge.

2.5 Fund Finance

Borrowing for AIFs is accessible on market-standard conditions, even though not many financial institutions have developed a dedicated desk to fund finance. Restrictions on borrowing are usually regulated in the relevant constitutional document of the AIF, and may include the term of duration and the maximum assets compared to total assets of the AIF, and are reflected in the relevant financing agreement, provided that the AIFMD leverage regulation applies.

A revolving credit facility for a maximum single duration of six or 12 months is the most common instrument used by AIFs, specifically to manage short-term liquidity needs or to rationalise the timing of capital calls. Lenders usually take forms of security, the magnitude of which depends on the amount of the financing and the relevant complexity. The most common form of security is a pledge on the cash available on the AIF's bank accounts. Financing agreements regulating fund finance usually provide for specific remedies upon the occurrence of an event of default, such as the ability of the lender, subject to certain conditions, to issue drawdown notices to investors on behalf of the AIFM, in order to ask investors to pay – out of their undrawn commitments – the balance of the outstanding financing.

2.6 Tax Regime

Direct Taxes

Under Italian tax law, alternative funds established in Italy are deemed to be resident therein for income tax purposes, regardless of their legal form, and are liable to Italian corporate income tax (IRES), generally applied at a rate of 24%.

Italian tax law establishes that proceeds realised by Italian alternative funds are exempt from IRES.

As a consequence, proceeds realised by alternative funds arising from their investments will be received gross of any Italian withholding tax or substitutive tax (with some exceptions – eg, under certain conditions, interest from certain unlisted bonds), and will not be subject to Italian income taxes.

Italian AIFs are not liable to Italian local operating profit tax (IRAP), ordinarily applied at a rate of 3.9%.

Based on the wording of Italian tax law, and according to the interpretation of the Italian tax authorities, Italian alternative funds (even those under contractual form) are entitled to the application of the double taxation treaties entered into by Italy, and may request that the Italian tax authorities issue a tax residence certificate supporting their status for such purposes. However, the actual application of the double taxation treaties depends on the interpretation of the sourcing state.

Indirect Taxes

Management fees invoiced by the management company to the funds are exempt for Italian value-added tax (VAT) purposes (no Italian VAT will be charged on management fees), but fees due to the depository may trigger some VAT leakage. Indeed, the Italian tax authorities have taken the view that certain services rendered by the depository (eg, custody services and mandatory supervision services) will trigger VAT at a rate of 22%, and some others (eg, net asset value calculation) will be treated as VAT-exempt. As a consequence, Italian VAT applied by the depository in the first case will not generally be recoverable in the hands of the funds.

The Italian tax authorities have clarified that services that are “strictly connected” and specific to, and essential for, the management of AIFs (eg, certain fees charged by advisory companies or placement agents) are treated as exempt. According to the Italian tax authorities, certain services (eg, compliance, internal audit and risk management) can be considered as VAT-exempt where such services are rendered under an “outsourcing” process for regulatory purposes (*esternalizzazione di funzioni*).

Operations carried out by real estate funds (purchase/sale/lease of real estate properties) may be subject to VAT, depending on the nature of the transaction. The management company of the investment fund is deemed to be the taxable person for VAT purposes for the activities carried out by the fund. The fund’s VAT liability is determined separately from that of the management company and that of the other funds managed by the same management company.

The tax treatment of proceeds arising in the hands of alternative fund investors depends on both the type of proceeds and the type of investors.

Tax Regime of Investors Into AIFs (Other Than Real Estate Funds)

Any amount received that can be regarded as capital reimbursement is not subject to taxation. In this regard, the actual qualification of the sums distributed must be verified based on the information provided by the management company itself upon the relevant payments.

For funds other than real estate investment funds, a 26% (final or advanced) withholding tax is generally applied by the investment fund's management company on proceeds arising from such investments. In particular, reference will be made to proceeds from:

- distributions of the fund (either in cash or in kind); and
- liquidation of the funds or redemption/transfer of the funds' units – in such a case, the taxable base of the proceeds is determined as the difference between the value of the units on the redemption/liquidation/transfer date and the weighted average subscription/purchase price.

In more detail, proceeds realised by Italian resident investors holding fund units as private assets are subject to a 26% final withholding tax, to be applied by the management company.

For proceeds arising from the transfer of fund units, the 26% final withholding tax must be levied by the management company or by the Italian financial intermediary that has been engaged by the investor to manage the transfer of the fund units. If the management company or any other Italian financial intermediary does not act as the withholding tax agent with regard to such proceeds, the investor will be required to include them in its annual income tax return and autonomously pay the final substitute tax at a rate of 26%.

The above 26% withholding tax does not apply to proceeds paid to (or realised by) Italian individual investors holding the fund units through a portfolio that is subject to the "discretionary portfolio regime" (*regime del risparmio gestito*). Such proceeds are included in the increase of the portfolio's net asset value, and are potentially subject to 26% taxation on an accrual basis.

Proceeds realised by Italian resident investors holding the fund units as business assets, entities engaged in entrepreneurial activity and permanent establishments of foreign investors qualify as business income and are fully subject to tax in the hands of the recipient (eg, 24% IRES for Italian resident companies or 27.5% IRES for banks), and also to IRAP for some taxpayers (eg, banks). A 26% advance withholding tax is levied upon the payment of such proceeds by the management company, but is not applicable to proceeds realised by insurance companies if the fund units qualify as assets allocated to cover the actuarial reserves according to the applicable life insurance regulations.

Italian non-mandatory pension funds (*forme di previdenza complementare*), Italian undertakings for collective investment and Italian real estate investment funds are not subject to tax with regard to proceeds arising from an investment into alternative funds, and no withholding tax or substitute tax is withheld and/or levied by the management company on such proceeds.

Proceeds realised by non-resident investors from a participation in an alternative fund are, in principle, subject to 26% withholding tax, to be levied by the management company. However, no withholding tax applies on proceeds paid out by alternative funds, provided that the foreign recipient does not have a permanent establishment for tax purposes in Italy and is either:

- the beneficial owner of the income and resident for tax purposes in a country that grants an adequate exchange of information with the Italian tax authorities ("White List Countries"); or

- an "institutional investor" established in a White List Country.

The definition of "institutional investor" for these purposes includes:

- entities that are subject to regulatory supervision in the state in which they are incorporated or created (eg, foreign banks and insurance companies);
- entities that have specific expertise in investment in financial instruments (eg, foreign investment funds), including tax-transparent entities not subject to regulatory supervision; and
- entities that have been set up with the exclusive purpose of managing investments for institutional investors that are subject to regulatory supervision, including tax-transparent entities that are not subject to regulatory supervision, provided that both such institutional investors and the management company of the entity are established in White List Countries.

The exemption also applies to entities or international bodies set up in compliance with international treaties that are in force in Italy, and to central banks or organisations, as well as managing official state reserves.

The White List Countries are numerous, and include the vast majority of countries of residency/establishment of institutional players and international financial firms (eg, the EU, the UK, the USA, Cayman Islands, BVI, Liechtenstein, UAE, Singapore, Jersey, Guernsey).

In order to obtain the above-mentioned exemption from Italian taxation, non-Italian resident investors must deposit the units with an Italian qualifying financial intermediary and submit proper documentation and self-declaration to the management company, stating the fulfilment of the requirements to benefit from the exemption.

If there is a negative difference between the sale and the purchase price (increased by any cost or expense related to the acquisition of the fund units), the latter amount can be used to offset other income, with certain limitations, depending on the nature of the investor.

Tax Regime of Investors Into Real Estate Funds

Distributions of proceeds from real estate investment funds to resident investors are subject to 26% (final or advanced) withholding tax, to be applied by the management company. Proceeds included in the positive difference between the redemption or liquidation value of a fund's units and their average subscription or acquisition price are subject to the same tax treatment. No withholding tax applies to Italian non-mandatory pension and investment funds.

In order to counteract tax-abusive structures, Italian tax law provides for certain anti-abuse provisions where the above regime does not apply to Italian resident investors (the fund is treated as tax-transparent – ie, the taxpayer is taxed on proceeds realised by the fund, regardless of their actual distribution). This is the case where the investor holds (directly or indirectly) more than 5% of the fund. However, such anti-abuse rules will not be applicable if the investor qualifies as an "institutional investor" (eg, banks, insurance companies and investment funds).

Non-resident investors are subject to 26% final Italian withholding tax (or the lower tax rate on outbound interest payments according to the provisions of any applicable double taxation treaties).

Foreign "institutional investors" without a permanent establishment for tax purposes in Italy are exempt from the 26% withholding tax, provided that they are established in a White List Country. The definition of "institutional investors" for the purposes of the exemption at hand (which differs from the one applicable in respect of non-real estate investment funds) includes:

- foreign pension funds and foreign investment funds;
- international bodies established on the basis of international treaties that are valid in Italy; and
- central banks or entities that manage the state's official reserves.

According to the interpretation of the Italian tax authorities, foreign investment funds are entitled to the exemption when the following requirements are fulfilled:

- the foreign investment funds can be compared, regardless of their legal form and their liability to tax, to Italian regulated AIFs from a substantial standpoint having the same purposes; and
- the foreign investment funds (or their management companies/advisers) are subject to regulatory supervision.

Capital gains realised upon the sale of real estate fund units by Italian resident investors holding fund units as private assets and by non-resident investors are subject to 26% substitutive tax. If the units are held in the context of a business activity, the relevant capital gain is included in the taxable base, and ordinarily subject to IRES/personal income tax.

The 26% substitutive tax on capital gains does not apply to the following non-resident investors:

- investors who are the beneficial owners of the income and are resident for tax purposes in White List Countries;
- "institutional investors" established in White List Countries – the same definition applies as for the exemption from withholding tax on proceeds from Italian non-real estate investment funds described above under "Tax Regime of Investors Into AIFs (Other Than Real Estate Funds)";
- entities or international bodies set up in compliance with international treaties that are in force in Italy; or
- central banks or organisations that also manage official state reserves.

The exclusion of Italy's right to taxation in respect of capital gains realised by a non-resident taxpayer upon the sale of a participation in an Italian real estate fund can also be granted under any applicable double taxation treaties.

Carried Interest Schemes

Italian tax law provides that, if certain requirements are met, proceeds realised by Italian tax-resident individuals under carried interest schemes will be treated as income from capital and therefore subject to substitutive taxation, to be applied at a rate of 26%.

The applicable legal provision does not introduce a special regime but rather clarifies the circumstances under which the carried interest proceeds have a financial nature, regardless of the existence of an employment relationship between the unitholder and the fund (or its manager/adviser).

The tax regime applies to directors and/or employees of entities who have a direct or indirect control, management or advisory relationship with the fund (or its manager/adviser). The conditions required to "secure" the qualification as income from capital are as follows:

- carry holders must commit themselves to actually invest an amount equal to at least 1% of the total investment of the fund;
- proceeds from the units will be payable only if all investors have received full repayment of the invested capital and a certain return ("hurdle") provided under the relevant by-laws/rules of the fund; and
- a five-year minimum holding period is observed, or, in a change-of-control scenario, the units are held until that date.

In determining the 1% threshold, relevance will also be attributed to:

- ordinary units in the funds, held by the carry holders (ie, co-investments); and
- the value of the (ordinary or carry) units attributed to the carry holders as a benefit in kind and taxed as employment income.

If the above requirements are not met, analysis will be carried out on a case-by-case basis to assess whether there is any risk that the carry proceeds may be qualified as employment income, subject to:

- personal income tax at progressive tax rates (eg, equal to 43% on taxable income exceeding EUR50,000);
- a 10% surcharge applicable on employment income received by managers of entities operating in the financial sector (eg, banks and AIFMs) when the variable compensation (eg, bonuses and stock options) of the manager exceeds one time their annual fixed salary; and
- related local (eg, municipal and/or regional) surcharges (if applicable).

Other Taxes

No stamp duty, registration duty or other duties, taxes or fees are required to be paid upon the subscription of the fund units. No capital duty is levied on the subscription of the fund units or the drawdown payments to be made by the investors into the funds.

As a general rule, the execution of the documentation connected with the investment into the fund units is not subject to Italian registration tax. Where the execution of the documentation is carried out through either a notarial deed or a notarised agreement, registration tax will be due, at a fixed amount equal to EUR200. Non-notarised agreements are subject to registration tax, at a fixed amount equal to EUR200, only in the case of use.

Both Italian resident investors and non-Italian resident investors who fall within the definition of "clients" for regulatory purposes are subject to Italian stamp duty on periodical communications related to fund units. The stamp duty at hand is applied on a yearly basis by the management company at a rate of 0.2%, on a taxable base equal to the fair market value of the fund units and, in the absence thereof, to their nominal or reimbursement value as periodically communicated by the management company. The stamp duty due from "clients" other than individuals is capped at EUR14,000.

The transfer of fund units is not subject to the Italian financial transaction tax, ordinarily applied at a rate of 0.2%.

Tax Incentives

Under Italian tax law, there are several special tax regimes providing incentives for investing into Italian investment funds. In general, such incentives are granted as exemptions from tax on proceeds arising from the investment and differ according to the nature of the investor and/or the investment fund.

Italian pension funds

Mandatory Italian pension funds (such as *enti di previdenza obbligatoria and casse di previdenza*) and other non-mandatory Italian pension funds making long-term investments (with a holding period of at least five years) into, inter alia, Italian/EU alternative funds may benefit from an exemption from tax on the proceeds arising therefrom.

The investment funds qualifying for the above exemption must invest most (more than 51%) of their capital into shares issued by companies that are tax-resident in Italy, or that are based in EU/EEA countries but have a permanent establishment for tax purposes in Italy.

Assets whose proceeds benefit from the exemption are capped at 10% of the total assets of the pension funds.

"Ordinary" long-term individual investment plan (PIR ordinari)

A PIR is defined as the pool of qualified financial instruments and cash that is entitled to a special tax regime if certain requirements are met. This special tax regime is available to Italian tax-resident individuals only, and entails the following:

- an exemption from personal income tax (or substitutive taxation) on the proceeds arising from the financial assets underlying the PIR; and
- an exemption from inheritance taxation on the financial instruments included in the PIR, in the case of the death of the holder of the PIR.

The financial instruments included in the PIR must be held for at least five years, and the annual incentivised investment is limited to EUR40,000. The overall investment into the PIR may not exceed EUR200,000. The latter thresholds were set at EUR30,000 and EUR150,000, respectively, for PIRs established up until the end of 2021.

For PIRs set up from 2020 onwards, the amount invested into the PIR will be allocated during each year and for at least two-thirds of the year as follows.

- 70% into financial instruments (eg, equity, bonds, non-speculative derivatives), even if not listed on a stock exchange, that are issued by Italian tax-resident enterprises or enterprises that are tax-resident in the EU or EEA and have a permanent establishment for tax purposes in Italy, with the following qualifications:
  - (a) 25% out of the 70% (ie, 17.5% of the overall amount invested into the PIR) into financial instruments issued by Italian tax-resident companies that are not listed on the FTSE MIB index of the Italian Stock Exchange or other major foreign indexes; and
  - (b) 5% out of the 70% (ie, 3.5% of the overall amount invested into the PIR) into financial instruments issued by Italian tax-resident companies that are not listed on the FTSE MIB and FTSE Mid Cap index of the Italian Stock Exchange or equivalent.
- The remaining part (the free quota) will not be subject to such limitations and may be invested into other financial instruments or

cash equivalents (ie, time deposits, bank accounts), if compliant with the other requirements (eg, concentration).
- A concentration limit of 10% applies.

Mandatory Italian pension funds and other non-mandatory Italian pension funds may also set up more than one PIR benefitting from the exemption from taxation on proceeds.

Italian/EU investment funds may serve as qualified underlying investments of a PIR, if their investment policy is compliant with the requirements above (so-called PIR-compliant funds). A PIR may also be set up by subscribing for units of an Italian investment fund.

As the target of the PIR incentive is mostly non-professional investors, retail funds units are usually preferred to alternative investment ones (which are more often used as indirect investments of a PIR scheme).

"Alternative" long-term individual investment plan (PIR alternativi)

The "alternative" PIR was introduced in 2020 as a new type of PIR. The tax benefits are the same as apply to the "ordinary" PIR: exemption from taxation on proceeds and from inheritance tax. The main differences are as follows:

- the annual incentivised investment is increased to EUR300,000, and the overall investment into the "alternative" PIR may not exceed EUR1.5 million;
- at least 70% is invested into financial instruments issued by Italian tax-resident companies that are not listed on the FTSE MIB and FTSE Mid Cap index of the Italian Stock Exchange or equivalent, or into financings or credits towards the same companies; and
- concentration limits are increased to 20%.

As of 2022, a taxpayer can benefit from the incentives of more than one "alternative" PIR in addition to only one "ordinary" PIR but subject to an overall maximum invested cap of EUR300,000 per year and EUR1.5 million in total.

Mandatory Italian pension funds and other non-mandatory Italian pension funds may also set up more than one "alternative" PIR and they are not subject to the above-mentioned maximum investment thresholds.

The law introducing the "alternative" PIR repealed the tax incentive applicable to ELTIFs that was introduced in 2020 but that never came into effect, pending the authorisation of the EU Commission.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Please see **2.1.1 Fund Structures** (reference to SICAFs will be interpreted, mutatis mutandis, as reference to *société d'investissement à capital variable* – SICAVs).

Instead of the SICAF, legislation provides for the possibility to use the SICAV structure (ie, a joint stock company with variable capital). The peculiarity of SICAVs, as compared to mutual funds, is that the investor becomes a shareholder of the company and therefore acquires a series of patrimonial rights (right to profits and capital redemption following the redemption request) and administrative rights. Like mutual funds, the capital of a SICAV is not fixed, but varies according to new subscriptions and redemption requests.

SICAVs are open-ended entities: an investor can always subscribe to new shares and request their redemption. This also shows a main difference compared to SICAFs (the legal structure that might be used by an AIFM to establish an AIF): the share capital is not fixed, but is equal to the net assets, which vary according to new subscriptions and redemptions. The shares representing the capital must be fully paid up when they are issued, and contributions can only be made in cash.

A SICAV may directly manage its assets or delegate the management thereof to an asset management company; it may also carry out the related and instrumental activities established by the Bank of Italy, after consulting CONSOB, provided that the proper performance of the main business activity is guaranteed. As regards management limits, the legislature has laid down rules for SICAVs similar to those laid down for open-ended mutual funds.

3.1.2 Common Process for Setting Up Investment Funds

Please see **2.3.4 Regulatory Approval Process**.

3.1.3 Limited Liability

Please see **2.1.3 Limited Liability**.

3.1.4 Disclosure Requirements

Please see **2.1.4 Disclosure Requirements**. The management rules of the retail funds (other than AIFs) provide for the obligation of the AIFM to calculate the net asset value and to publish the relevant value on a bi-monthly basis.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

In addition to the categories of investors indicated under **2.2.1 Types of Investors in Alternative Funds**, it is worth noting that retail funds, by definition, can be subscribed by every category of investors without distinctions and minimum amounts. In addition, banks and investment firms play an important role in the fundraising process of retail funds, marketing the relevant units to their retail clients.

3.2.2 Legal Structures Used by Fund Managers

Please see **2.2.2 Legal Structures Used by Fund Managers**.

3.2.3 Restrictions on Investors

There are no specific restrictions regarding the types of investors that can invest in a retail fund, provided that, before establishing a new retail fund, the relevant fund manager identifies the specific target market applicable to such fund – ie, the categories of individuals that can subscribe to the relevant units/shares (positive target market) and the categories of individuals that cannot subscribe to the relevant units/shares (negative target market), according to the MiFID II provisions regulating product governance, as adopted by Italian legislature.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

Retail funds are subject to the relevant provisions included in the UCITS Directive, as adopted by the Regulations on Collective Asset Management adopted by the Bank of Italy on 19 January 2015. On a general note, retail funds invest their assets as follows:

- consistently with their investment policy;
- in assets whose risks are adequately controlled within the risk management system;
- in assets that are liquid, so as not to jeopardise the obligation of the fund to redeem the units at any time in accordance with the management rules; and

- in respect of which the maximum potential loss that the fund may incur is limited to the consideration paid for the relevant purchase/subscription, with the exception of certain financial derivatives.

While managing the relevant retail fund, the following is not permitted:

- to grant loans other than those provided for in respect of forward transactions in financial instruments;
- to sell short financial instruments (without prejudice to certain specific provisions with regard to limits on taking short positions in financial derivative instruments);
- to invest in financial instruments issued by the same fund manager managing the fund;
- to purchase precious metals and stones or certificates representing them; or
- to invest in assets directly or indirectly transferred or conferred by a shareholder holding qualified shareholdings, by a director, general manager or statutory auditor of the fund manager, or by a company of the relevant group, nor to sell or otherwise dispose of such assets directly or indirectly to directors, statutory auditors or the general manager of the fund manager.

3.3.2 Requirements for Non-Local Service Providers

Please see **2.3.2 Requirements for Non-local Service Providers.**

3.3.3 Local Regulatory Requirements for Non-Local Managers

Please see **2.3.3 Local Regulatory Requirements for Non-local Managers.**

3.3.4 Regulatory Approval Process

Please see **2.3.4 Regulatory Approval Process.**

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Currently, there is no pre-marketing legislation applicable to the pre-marketing of retail funds in Italy (since the pre-marketing regime is only applicable vis-à-vis professional investors).

3.3.6 Rules Concerning Marketing of Retail Funds

Please see **3.2.3 Restrictions on Investors**.

3.3.7 Marketing of Retail Funds

Please see **3.2.3 Restrictions on Investors**.

3.3.8 Marketing Authorisation/Notification Process

Italian AIFMs willing to market a retail AIF (either Italian or EU) must submit advance notification to CONSOB, and can start marketing once the relevant no-objection communication has been issued by CONSOB, provided that the relevant management rules have received the prior approval of the Bank of Italy (see **2.3.4 Regulatory Approval Process**). The notification must include the rules governing the AIF, the offering document, and information requested by Article 43 of the UFA, such as the identity of the custodian, the description of the AIF (including information on the term of the AIF, the investment policy, the fees' level and whether the AIF accumulates or distributes the proceeds) and the other documentation listed under Annex III or IV of the AIFMD. The process takes around 20 days to be completed.

3.3.9 Post-Marketing Ongoing Requirements

Amendments to the management rules of retail funds are subject to the prior approval of the Bank of Italy.

3.3.10 Investor Protection Rules

Please see **2.3.10 Investor Protection Rules.**

3.3.11 Approach of the Regulator

Please see **2.3.11 Approach of the Regulator**.

3.4 Operational Requirements

In the exercise of its management activity, the retail fund may – up to a maximum of 10% of the total net value of the fund – take out loans to cover temporary mismatches in treasury management, in relation to the investment or disinvestment needs of the fund's assets.

The duration of the loans taken out must be related to the purpose of the debt and in any case may not exceed six months. In the case of short-term borrowing, its use must be characterised by a high degree of elasticity. Within the above limits, loans in a foreign currency with a deposit with the lender of a corresponding amount of domestic currency (so-called back-to-back loans) are not counted.

3.5 Fund Finance

Please see **2.5 Fund Finance**.

3.6 Tax Regime

Please see **2.6 Tax Regime**.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

AIFMD2

Directive (EU) 2024/927 ("AIFMD2") brings a range of amendments to the regulatory framework for alternative investment funds (AIFs), which merit close attention from fund managers and market participants. Notably, it introduces provisions targeting loan-originating AIFs, aiming to harmonise practices across Member States while permitting tailored national implementations.

Key amendments include the following.

- A definition of "loan origination" that extends beyond direct lending to include indirect arrangements through third parties or special purpose vehicles. This applies where the AIF or its manager is involved in structuring the loan, defining its terms, or agreeing its preliminary characteristics prior to assuming exposure.
- Introduction of "loan-originating AIFs", defined as:
  - (i) AIFs whose primary investment strategy is to grant loans; or
  - (ii) AIFs where granted loans represent at least 50% of the fund's net asset value.
- Concentration limits, restricting loan-originating AIFs from lending more than 20% of their assets to a single borrower, if it is an AIF, a UCITS or a financial undertaking.
- Leverage restrictions, which impose the following limits:
  - (i) 175% for open-ended AIFs; and
  - (ii) 300% for closed-ended AIFs.

A specific exemption applies for shareholder loans, defined as loans made to companies in which the AIF holds at least 5% of the capital or voting rights. Such loans cannot be transferred to third parties;

- Structuring flexibility, allowing loan-originating AIFs to be established as either open-ended or closed-ended funds, subject to criteria to be defined by ESMA. These criteria will assist national regulators in determining whether open-ended structures are suitable.

- Risk retention requirements, obliging loan-originating AIFs to retain 5% of the nominal value of loans transferred to third parties. Retention periods are defined as follows:
  - (i) until maturity, for loans with a term of up to eight years, or for loans to consumers; and
  - (ii) for at least eight years for other loans.
- Enhanced credit risk management requirements, obliging AIFMs to establish and maintain robust policies, procedures, and processes for assessing credit risk and managing loan portfolios. These must be reviewed and updated at least annually.
- Flexibility for Member States, which may:
  - (i) implement stricter rules for specific categories of AIFs; or
  - (ii) prohibit AIFs from granting loans to consumers for reasons of public interest.

AIFMD2 also provides transitional measures for certain requirements applicable to AIFs established prior to its adoption.

Implementation Timeline

The AIFMD2 must be transposed into national law by 16 April 2026, with certain reporting obligations on delegation agreements taking effect from 16 April 2027. In Italy, the implementation will require alignment with existing national legislation, including the Consolidated Law on Finance (TUF) and the Bank of Italy's Regulations on Collective Asset Management.

Supporting the Italian venture capital ecosystem

With the aim of increasing financial resources dedicated to the Italian start-ups and venture capital market, Article 33 of Law No 193 of 16 December 2024 (Annual Market and Competition Law), inter alia, introduced new rules that make the recognition of the aforementioned tax exemption regimes for mandatory Italian pension funds and other non-mandatory Italian pension funds on returns from, inter alia, certain investment funds (see "Tax Incentives" section of **2.6 Tax Regime**) subject to the condition that they invest in "Venture Capital" AIFs an amount equal to at least 5% of the basket of "qualified investments" (a maximum of 10% of their assets) resulting from the previous year's statements. This restricted portion in favour of investments in "Venture Capital" AIFs will increase to 10% of the basket of "qualified investments" from the year 2026.

Additionally, Law No 162 of 28 October 2024 introduced a key amendment concerning the SIS (see the "Fund Structures" section of **2.1 Fund Formation**) as part of a broader reform aimed at introducing tax incentives and investment benefits for start-ups and small and medium-sized enterprises (SMEs). In this context, the maximum net asset threshold for SIS was raised from EUR25 million to EUR50 million, thereby expanding their investment capacity.

Trends and Developments

Contributed by:
Emidio Cacciapuoti, Giorgio Bobba and Davide Massiglia
ADVANT Nctm

ADVANT Nctm Studio Legale's investment funds practice in Italy offers expertise in legal, regulatory and tax matters. The firm advises clients that are active in all sections of the funds market, including private equity, real estate, venture capital, debt, infrastructure funds, credit funds and funds of funds. Its lawyers provide assistance on fund formation for sponsors/managers, fund reviews for investors, on carried interest, incentive schemes and co-investment plan structuring, reorganisations and spin-outs, secondary transactions, private equity house mergers, fund governance, transaction structuring and fund-level finance arrangements, including investor call, equity bridge, co-investment and warehousing facilities. The team has unrivalled experience in the Italian market, having assisted a number of general partners acting in different sectors on their most recent fundraising and structuring initiatives.

Authors

Emidio Cacciapuoti is a partner at ADVANT Nctm Studio Legale, and focuses on the tax and regulatory aspects of funds, alternative investment fund structures and carried interest schemes. He obtained an LLM cum laude in International Taxation from Leiden University, and is a member of the Tax and Legal Committee of AIFI and the International Tax Working Group of Invest Europe. He serves as a member of the board of directors of Italian AIFMs. He co-authored the chapter on "Fund structuring in Italy" in "Global Tax Considerations in Private Fund Formation" (Private Equity International, 2016) and is the author of the AIFI book on "Fundraising in Private Equity – Terms and conditions" (Egea, 2016).

Giorgio Bobba is a counsel at ADVANT Nctm Studio Legale, and focuses his practice on banking and finance, particularly on advising corporate and commercial enterprises on the regulations governing financial intermediaries and the financial markets. He has developed specific knowledge of financial derivatives and ISDA transactions, and has a wealth of experience in private equity and venture capital transactions, project finance, investment in primary and secondary markets, market abuse and tender offers. He is admitted to the Milan Bar and serves as a member of the board of directors and as company secretary of Italian AIFMs and financial intermediaries.

Davide Massiglia is a counsel at ADVANT Nctm Studio Legale, and works primarily on investment funds, international taxation, corporate income taxation, M&A, Italian and international tax planning for high-net-worth individuals and taxation of real estate investments. He regularly advises managers and investors on fund formation and structuring, carried interest and transaction structuring, including financings. He graduated cum laude from Genoa University, and is a member of the International Fiscal Association. He serves as a member of the board of directors and as statutory auditor of Italian AIFs and financial intermediaries. He co-authored the chapter on "Fund structuring in Italy" in "Global Tax Considerations in Private Fund Formation" (Private Equity International, 2016).

ADVANT Nctm Studio Legale

Via Agnello 12
20121 Milan
Italy

Tel: +39 0272 5511
Fax: +39 027 255 1501
Email: bd@advant-nctm.com
Web: www. advant-nctm.com

ITALY TRENDS AND DEVELOPMENTS

Contributed by: Emidio Cacciapuoti, Giorgio Bobba and Davide Massiglia, **ADVANT Nctm**

The private equity market in Italy has continued to evolve significantly over the past year, shaped by a dynamic global environment and emerging local trends. Below is an updated analysis of key developments and considerations for 2025.

Macroeconomic Backdrop and Market Impact

The economic environment remains influenced by the effects of inflationary pressures and monetary tightening policies initiated over the last few years. While the quantitative tightening measures adopted by central banks aimed to reabsorb market liquidity, 2024 saw inflation rates stabilise, particularly in the eurozone. However, high interest rates endure, affecting private capital markets by raising the cost of debt financing.

In parallel, geopolitical uncertainties, including the prolonged effects of the Ukraine conflict and tensions in energy markets, have continued to impact investor sentiment.

Fundraising and Investment Trends

The following three areas are worthy of mention.

- *Focus on technology and sustainability* – investments in technology remain a cornerstone of private equity activity, driven by EU development policies. At the same time, sustainability has become a critical focus area, with investors prioritising firms that integrate ESG considerations throughout the investment lifecycle.
- *Impact on first-time funds* despite market improvements, first-time funds continue to face challenges with regards to raising capital, particularly in a competitive environment where institutional investors gravitate towards established General Partners (GPs). However, public and semi-public investment vehicles, such as the European Investment Fund (EIF) and Cassa Depositi e Prestiti, remain essential supporters of emerging managers.
- *Introduction of continuation funds* – a major milestone for the Italian private equity ecosystem in 2024 was the establishment of the first continuation fund managed by an Italian Alternative Investment Fund Manager (AIFM) with respect to an Italian asset. In the past, continuation funds were extensively used to manage and extend the life of underperforming investments. The market has generally been lukewarm to these types of transactions on account of their “circular” nature. However, the last few years have seen a substantial increase in GP-led secondaries to help fund managers grow unicorns on behalf of secondary funds. This approach provides existing investors with liquidity while allowing GPs to continue creating value from their best-performing portfolio companies. The introduction of continuation funds has added flexibility to the market, offering an additional exit strategy and contributing to the maturity of Italy’s private equity landscape. It is expected that 2025 will see a significant increase in the creation and operation of continuation funds.

ESG

The ESG (Environmental, Social and Governance) agenda has cemented itself as a key priority for the private equity industry. The introduction of regulatory technical standards (RTS) under the Sustainable Finance Disclosure Regulation (SFDR) has resulted in additional compliance requirements for management companies.

Key 2025 Updates

- Italian fund managers have significantly ramped up efforts to align organisational structures with ESG requirements. These include enhanced sustainability reporting, integration of environmental risk assessments, and adaptation of internal policies to reflect institutional investor expectations.

- Institutional investors are increasingly rewarding managers with robust ESG credentials, leading to a shift from greenwashing practices to genuine value creation through sustainable investments.
- Challenges remain, particularly regarding the lack of standardised methodologies to measure ESG effectiveness. However, innovative solutions and collaborative industry efforts are being developed to address these gaps.

Conclusion

The Italian private equity market enters 2025 with strong momentum, underpinned by sustained interest in technology and sustainability, robust fundraising by established managers, and evolving regulatory frameworks that promote inclusivity and ESG integration. Despite enduring challenges, such as high-interest rates and geopolitical uncertainty, the industry is well-placed to deliver long-term value, consolidating its position as a cornerstone of the Italian financial ecosystem.

JAPAN

China
Russia
N. Korea
S. Korea
Japan
Tokyo

Law and Practice

Contributed by:
Kunihiko Morishita, Masayuki Hashimoto and Koichi Miyamoto
Anderson Mori & Tomotsune

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Anderson Mori & Tomotsune (AMT) is one of the largest and most international Japanese law firms, with a long history of advising overseas companies on cross-border transactions and on conducting business in Japan. The main office in Tokyo is supported by two regional offices, in Osaka and Nagoya, and ten overseas offices. AMT has considerable experience and expertise in investment funds, including investment corporations such as J-REITs, infrastructure funds, ETFs, partnerships and other forms of collective investment schemes. The firm works with increasingly diversified international and Japanese-based investment funds, including private equity funds, venture capital funds, hedge funds, funds of funds and commodity funds. Consisting of 15 partners and 45 associates, the team provides comprehensive advice at all stages of the procedures to which investment funds are subject, and supports clients in navigating a broad range of regulatory matters concerning asset management.

Authors

Kunihiko Morishita is a leading partner at AMT, and focuses primarily on domestic and international banking, securities and asset management. He is a member of the Financial Law Board, and has extensive knowledge and experience in representing financial institutions. This includes representing investment management companies when dealing with the Financial Services Agency as well as other Japanese regulatory authorities. He regularly advises numerous multinational financial institutions, located both within and outside of Japan, regarding securities, trusts and asset management.

Masayuki Hashimoto is a key partner at AMT, and specialises in the establishment and marketing of domestic and foreign investment trusts and other investment fund vehicles. He oversees the incorporating and listing of J-REITs, the issuance, offering and sale of investment units of J-REITs, the establishment and registration of investment companies, and the compliance of securities firms and other financial institutions. He also has substantial experience in capital markets, securities and financial regulations, and in-depth knowledge of the Financial Instruments and Exchange Act and the Investment Trusts Act.

Koichi Miyamoto is a partner at AMT and specialises in financial regulatory issues, covering the Financial Instruments and Exchange Act and the Investment Trusts Act. His professional experience includes providing legal services and advice on the structuring, formation and marketing of domestic and foreign investment funds, including private equity funds, venture capital funds, real estate and infrastructure funds, as well as asset management, fintech and various types of financial transactions. He previously worked with the Securities and Exchange Surveillance Commission of Japan (2008–2010), where he managed and directed the inspection of financial instruments business operators.

Anderson Mori & Tomotsune

Otemachi Park Building
1-1-1 Otemachi
Chiyoda-ku
Tokyo 100-8136
Japan

Tel: +81 367 751 000
Email: inquiry@amt-law.com
Web: www.amt-law.com

1. Market Overview

1.1 State of the Market

Financial assets held by Japanese households have been increasing steadily for years, now reaching over JPY2,100 trillion. Building on this, a number of various types of investment funds are being marketed, offered and distributed in the Japanese market. The most widely used form of investment fund in Japan is an investment trust (*toushi shintaku*), created pursuant to the Act on Investment Trusts and Investment Corporations of Japan (the Investment Trusts Act), which is offered on both retail markets (through public offerings) and institutional markets (mostly through private placements).

The Investment Trusts Act also provides for an investment corporation (*toushi houjin*), which is typically used for real estate investments and is popularly known as a Japanese Real Estate Investment Trust (J-REIT). This is something of a misnomer given that all existing J-REITs use the form of an investment corporation rather than being structured as trusts.

In addition, offshore investment funds domiciled in jurisdictions such as the Cayman Islands, Luxembourg and Ireland and qualified as foreign investment trusts/corporations under the Investment Trusts Act have long been used to provide access to the global market for Japanese investors.

Lastly, collective investment schemes such as investment limited partnerships under the Limited Partnership Act for Investment of Japan (LPAI) and silent partnerships under the Commercial Code also account for a substantial portion of investment funds in certain areas, such as private equity funds, as do leasing funds such as aircraft leasing funds, because those are generally treated as pass-through entities for Japanese taxation purposes. Furthermore, offshore collective investment schemes such as Cayman limited partnerships and Luxembourg common and special limited partnerships are preferred in cross-border transactions because of their flexibility and global recognition.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

While there is no specific category analogous to alternative investment funds under Japanese law, privately placed investment funds are used in practice to provide alternate investment opportunities to Japanese investors.

With respect to publicly offered investment trusts/corporations, the Investment Trusts Association, Japan (ITAJ – a self-regulatory organisation of investment trust managers and asset management companies for investment corporations) provides detailed requirements on the management and administration of portfolio assets of publicly offered investment trusts/corporations. Please see **3.3.1 Regulatory Regime** for more details on the rules of the ITAJ.

On the other hand, privately placed investment trusts/corporations are often created and tailored to meet specific investment purposes, strategies and risk allowances of potential investors. In addition, collective investment schemes are, in general, offered by way of private placement because of their nature and their high flexibility in terms of their organisation, capital structure, types of underlying assets, dividend policies and fee schedules.

Therefore, for the purpose of this article, privately placed investment funds are treated as alternative investment funds.

2.1.2 Common Process for Setting Up Investment Funds

Investment Trusts

An investment trust is generally established by a trust agreement between an investment trust manager and a trustee. An investment trust manager must be a person registered as an investment management business under the Financial Instruments and Exchange Act of Japan (FIEA) ("Registered Investment Manager"), and a trustee must be a trust company licensed under the Trust Business Act or a financial institution authorised to engage in trust business under the Act on Engagement in Trust Business by Financial Institutions.

An investment trust must invest more than half of its assets in securities, derivatives, real estate, commodities and other assets specified by the regulation under the Investment Trusts Act ("Specified Assets").

An investment trust manager intending to enter into a trust agreement has to notify the regulator of the terms and conditions thereof in advance, and these must contain items such as the investment objective, policy, restrictions, dividend policy, method of calculation of net asset value and procedures for the issuance and redemption of units.

Investment Corporations

In order to incorporate an investment corporation, promoters must prepare a certificate of incorporation, which must be executed by all of the promoters; the promoters must notify the regulator of their intention to that effect. At least one promoter must be a Registered Investment Manager or must have the experience and knowledge specified by the Investment Trusts Act.

A certificate of incorporation must include the investment corporation's:

- purpose;
- investment policy;
- types of assets;
- dividend policy;
- valuation method of assets; and
- fees and charges.

As with an investment trust, an investment corporation must invest more than half of its assets in Specified Assets.

Subscribers for shares must contribute capital in cash into an investment corporation at the time of incorporation in exchange for an issuance of new shares. The minimum contributed capital and the net asset value at the incorporation are JPY100 million and JPY50 million, respectively.

An investment corporation is established upon the registration of its incorporation.

In order to ensure that an investment corporation functions solely as an investment vehicle, the Investment Trusts Act prohibits it from engaging in business other than asset management and the hiring of employees. As such, an investment corporation must retain an asset management company, a custody company and an administrative agent, and must delegate the relevant functions to them. An investment corporation must be registered by the regulator with the basic terms of its certificate of incorporation, the names of executive and supervisory directors, and the name of an asset management company before commencement of its operations.

Foreign Investment Trust/Corporations

The Investment Trusts Act defines a foreign investment trust/corporation as an investment fund established or incorporated outside Japan under the laws and regulations of a foreign jurisdiction, which is similar to an investment trust/corporation. Therefore, a close review of whether an offshore investment fund is treated as a foreign investment trust/corporation under the Investment Trusts Act is required before introducing it into Japan.

A foreign investment trust/corporation must file a "notification" with the regulator before conducting an offering (whether private placement or public offering) in Japan under the Investment Trusts Act, containing basic terms such as its investment objective, restrictions, dividend policy, procedures of subscription and redemptions, and costs and expenses.

No regulatory requirement is imposed on a manager, investment manager, asset management company or trustee in respect of a foreign investment trust/corporation.

Collective Investment Schemes

The establishment process and notification requirements for collective investment schemes are prescribed by the relevant laws governing such collective investment schemes. For example, an investment limited partnership formed pursuant to the LPAI becomes effective upon the execution of a partnership agreement by at least one general partner and one limited partner. When a partnership agreement takes effect, its business, its duration and the name of its general partner must be registered within two weeks.

The general partner of an investment limited partnership under the LPAI must be a Registered Investment Manager under the FIEA, unless an exemption from registration requirements is available.

An offshore partnership established under a foreign law can also be offered for private placement in Japan, although a general partner is required to be a Registered Investment Manager if any Japanese investor acquires and holds an interest in it, unless an exemption from registration requirements is available.

2.1.3 Limited Liability

Holders of units/shares in an investment trust/corporation are liable only to the extent of the amount contributed by them.

Liabilities of investors in collective investment schemes are determined by the relevant governing law. For example, a general partner of an investment limited partnership formed pursuant to the LPAI is jointly and severally liable for the obligations of the partnership, while a limited partner thereof is liable for the partnership's obligations only to the extent of its contribution of or commitment to contribute capital to the partnership.

2.1.4 Disclosure Requirements

In contrast to publicly offered investment funds (please see **3.1.4 Disclosure Requirements**), the disclosure requirements for privately placed investment funds are limited. However, for a private placement intended for Professional Investors only ("Professional Investors Placement"), certain information must be disclosed in accordance with the rules of the Japan Securities Dealers Association (JSDA – a self-regulatory organisation of securities firms, banks and other financial institutions operating in the securities business) (please see **2.3.6 Rules Concerning Marketing of Alternative Funds**).

An investment trust manager must provide a document detailing the trust agreement to investors seeking a subscription of units of an investment trust, except where the units are offered by way of a private placement for qualified institutional investors only ("QII Placement" – please see **2.3.6 Rules Concerning Marketing of Alternative Funds**).

An investment trust manager of an investment trust must prepare and deliver a management report containing performance results, market conditions and its financial statements for the relevant fiscal year to known unitholders, and must also send this report to the regulator after the end of the fiscal year without delay, unless the units of the investment trust are offered by way of a QII Placement and the terms and conditions of the trust agreement provide that a management report will not be delivered.

A management report is comprised of two types of reports:

- a summary management report, which contains material information; and
- a full management report.

In addition, the ITAJ provides detailed rules on matters to be included in a management report, and the forms necessary for drafting one. A full management report may be delivered to known unitholders through electronic means, including by posting the report on an issuer's website, as long as the terms and conditions of the trust agreement so allow.

An investment corporation must notify investors seeking a subscription of shares of the basic terms of a certificate of incorporation, such as its investment objective and its dividend policy, as well as its subscription requirements.

An investment corporation must prepare financial statements, an asset investment report and a statement on the distribution of funds for each fiscal period, and must send them to the shareholders once approved by a board of directors. An asset investment report must include material issues on:

- the situation of the investment corporation and other matters relating to the current situation;
- the directors; and
- its shares.

A foreign investment trust must deliver a document containing a constitutional document, such as the trust deed of a unit trust or a management regulation for a *fonds commun de placement* (FCP), to a prospective investor, and must prepare a management report and deliver it to known unitholders. A foreign investment corporation is not required to prepare an asset investment report.

With respect to a collective investment scheme, there is no general obligation of disclosure to a prospective investor, but a prospective investor is normally provided with a partnership agreement to review before executing it.

Ongoing disclosure obligations applicable to a collective investment scheme depend on the relevant governing law. For example, a general partner of an investment limited partnership formed pursuant to the LPAI must prepare a balance sheet, profit and loss statement and business report, and must maintain these at its principal office; a limited partner may inspect or request their own copies at any time during normal business hours.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

For both QII Placements and Professional Investor Placements, permitted investors are limited to qualified institutional investors and Professional Investors, respectively, as defined in the FIEA. Please see **2.3.6 Rules Concerning Marketing of Alternative Funds** regarding the requirements of private placement and **2.3.7 Marketing of Alternative Funds** for the scopes of QIIs and Professional Investors.

With respect to privately placed investment funds, most investors are persons who have knowledge and experience of investment in investment funds, such as banks, insurance companies, trust companies, Registered Financial Instruments Business Operators (as defined in **2.3.2 Requirements for Non-Local Service Providers**), wealthy individuals and general business companies with sufficient cash supplies.

2.2.2 Legal Structures Used by Fund Managers

Please see **2.1.2 Common Process for Setting Up Investment Funds**.

2.2.3 Restrictions on Investors

Please see **2.3.7 Marketing of Alternative Funds.**

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Most investment trusts are established as securities investment trusts for Japanese taxation purposes. In order to be qualified as a securities investment trust, a trust must invest more than half of its assets in securities (excluding certain "deemed securities" such as trust beneficiary interests in a trust and interests in a collective investment scheme such as an investment limited partnership) and securities-related derivatives.

The rules of the ITAJ require a real estate investment corporation to prescribe in its certificate of incorporation that its purpose is to invest more than half of its assets in real estate, lease rights and other real estate-related assets, such as asset-backed securities, more than half of the underlying assets of which are real estate and lease rights.

An investment limited partnership may acquire and hold stocks in joint stock companies (*kabushiki kaisha*), bonds issued by or loans issued to business entities, and other properties that facilitate the business of the entities. However, under the LPAI, unless the approval of the competent authorities is obtained, such a partnership is prohibited from acquiring and holding shares or convertible bonds in foreign companies to the extent that such securities represent half or more of its assets.

2.3.2 Requirements for Non-Local Service Providers

The FIEA provides four categories of financial instruments businesses:

- type I financial instruments business;
- type II financial instruments business;
- investment management business; and
- investment advisory business.

A person intending to be engaged in any such business must be registered under the FIEA as a Registered Financial Instruments Business Operator. Type I and II financial instruments businesses are involved in the services of brokerage, intermediary activity and the trading of liquid and illiquid securities (as the case may be) and their derivatives.

The Trust Business Act requires a trust company to be licensed thereunder in order to conduct a trust business. Accordingly, if a non-local service provider wants to carry out any such business in Japan or to provide the services of such business to clients resident in Japan, it must be registered under the FIEA or licensed under the Trust Business Act, as the case may be, unless it is exempted under applicable Japanese law.

2.3.3 Local Regulatory Requirements for Non-Local Managers

As mentioned in **2.3.2 Requirements for Non-Local Service Provider** s, registration is necessary in order to conduct an investment management business in Japan or to provide the services of such business to clients resident in Japan, under the FIEA. Therefore, if a non-local manager intends to act as an investment trust manager of an investment trust, an asset management company of an investment corporation or a general partner of an investment limited partnership, it must generally be a Registered Investment Manager under the FIEA.

On the other hand, acting as a manager or investment manager of a foreign investment trust or an asset management company of a foreign investment corporation outside of Japan does not require registration as an investment management business under the FIEA, while acting as a general partner of offshore collective investment schemes requires the registration if it involves accepting investments from residents in Japan.

2.3.4 Regulatory Approval Process

Generally speaking, the establishment process for an investment trust takes one to two months, whilst that for an investment corporation takes three to six months.

For a foreign investment trust/corporation, it usually takes one to two months to prepare and file a notification.

The length of time for the creation of a collective investment scheme depends on its type, its complexity and the number of investors involved, among other factors.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

Assuming that pre-marketing activities are those that are conducted towards the promotion and sale of securities but do not amount to solicitation thereof, they do not constitute public offerings or private placements under Japanese law.

However, the solicitation of securities is not expressly defined in the FIEA nor in any related law or guidelines. Nonetheless, under current practice, it is generally understood to mean any act carried out with a view to inducing or pressuring a targeted person to purchase a specific product or to agree to enter into a transaction. Accordingly, activities that are not within the parameters of such conduct would be regarded as pre-marketing activities under Japanese law.

In practice, however, it is difficult to draw a clear line between the solicitation of securities and pre-marketing activities, and this should be determined on a substantive basis considering all of the facts, including the wording used, the addressee of the information provided, and the reasons for the provision of the information.

In light of the above, activities such as simply answering questions posed by a potential investor (at the instigation of such potential investor) would be treated as pre-marketing. On the other hand, delivering a prospectus or sending marketing material containing past performance details of a specific investment fund is likely to be treated as solicitation of securities and must follow the requirements of the relevant private placement.

In the case of a foreign investment trust/corporation, an advance notification must be filed before conducting a private placement in Japan under the Investment Trusts Act (please see **2.1.2 Common Process for Setting Up Investment Funds**).

2.3.6 Rules Concerning Marketing of Alternative Funds

With respect to investment trusts/corporations, the FIEA principally provides for the following three methods of private placements:

- QII Placements;
- Professional Investor Placements; and
- private placements of small numbers of investors ("Small Number Placements").

It should be noted that any solicitation of securities that does not meet the requirements for private placements will generally be treated as public offerings under the FIEA.

Pursuant to a QII Placement, an issuer of an investment trust/corporation may offer its units/shares to an unlimited number of QIIs. An investor acquiring units/shares under the QII Placement is subject to a transfer restriction prohibiting any sale or transfer of units/shares to any person who is not a QII.

Professional Investor Placements have been made available relatively recently with respect to units/shares of investment trusts/corporations. Pursuant to a Professional Investor Placement, an issuer of such units/shares must disclose basic information regarding the units/shares and the issuer to the offerees, and must disclose information regarding the issuer on an annual basis to the holders of the units/shares, in accordance with the JSDA rules. In a Professional Investor Placement, the issuer may offer its units/shares to an unlimited number of Professional Investors. An investor acquiring units/shares under the Professional Investor Placement is subject to a transfer restriction prohibiting any sale or transfer of units/shares to any person other than a Professional Investor.

Pursuant to a Small Number Placement, an issuer may offer its units/shares to fewer than 50 offerees. This limitation is based on the number of offerees but not acquirers, and the number of QIIs can be excluded in calculating the number of offerees if they are subject to the requirements specified for a QII Placement (including transfer restriction). In addition, if units/shares of the same kind as the units/shares to be offered were issued during the three-month period preceding the scheduled issue date of the relevant private placement, the number of offerees of such preceding issue will be aggregated in calculating the number of offerees, which must be fewer than 50.

An investor acquiring units of an investment trust under a Small Number Placement is subject to a transfer restriction prohibiting any sale or transfer of units, unless it transfers all of its units as a whole, or unless certificates of units are unable to be divided. No transfer restriction is imposed on shares of an investment corporation issued pursuant to a Small Number Placement.

A foreign investment trust/corporation follows the same requirements as stated above (in case of a Professional Investor Placement, it must meet certain requirements provided by the JSDA rules applicable to a publicly offered foreign investment trust/corporation – please see **3.3.1 Regulatory Regime**).

With respect to collective investment schemes and offshore collective investment schemes, only Small Number Placements are available, pursuant to which an issuer may offer interests therein to up to 499 investors acquiring them.

In the case of a private placement, a written notification stating that a securities registration statement (SRS) has not been made because the offering is being made by way of a private placement must be delivered to an investor; said notification must include the applicable transfer restrictions.

2.3.7 Marketing of Alternative Funds

Under a QII Placement, units/shares can only be offered to QIIs, which include the following persons or institutions:

- Registered Financial Instruments Business Operators with registrations of type I financial instruments businesses and investment management businesses;
- investment corporations and foreign investment corporations;
- banks;
- insurance companies and foreign insurance companies;
- credit associations and labour credit associations;
- credit co-operative associations and agricultural co-operative associations;
- the Government Pension Investment Fund;
- the Japan Bank for International Cooperation;
- the Development Bank of Japan Inc.;
- investment limited partnerships;
- certain employee and corporate pension funds that have submitted a notification to the regulator;
- certain corporations that have submitted a notification to the regulator; and
- certain individuals that have submitted a notification to the regulator.

In a Professional Investor placement, the units/shares can only be offered to Professional Investors, including the following persons or institutions:

- QIIs;
- the government of Japan;
- the Bank of Japan;
- corporations incorporated under a specific law;
- investor protection funds;
- the Deposit Insurance Corporation of Japan;
- the Agricultural and Fishery Cooperative Savings Insurance Corporation;
- the Insurance Policyholders Protection Corporation of Japan;
- specific purpose companies;
- companies listed on a Japanese stock exchange;
- Japanese stock companies whose stated capital is reasonably expected to be equal to at least JPY500 million;
- Registered Financial Instruments Business Operators or corporations that are allowed to act as general partners of collective investment schemes by submitting notifications under the FIEA;
- foreign corporations;
- corporations that have requested to be treated as Professional Investors and have been approved by the Registered Financial Instruments Business Operator; and
- individuals who are operators of silent partnerships or equivalent to Professional Investors in terms of knowledge, experience and financial conditions and have requested to be treated as Professional Investors and been

approved by the Registered Financial Instruments Business Operator.

2.3.8 Marketing Authorisation/Notification Process

In the case of a foreign investment trust/corporation, a notification is required to be filed with the regulator before conducting an offering (please see **2.1.2 Common Process for Setting Up Investment Funds**).

2.3.9 Post-Marketing Ongoing Requirements

If an investment trust manager intends to change the terms and conditions of a trust agreement or implement a consolidation of investment trusts, the trustees of which are the same, it has to notify the regulator of its intention and the contents of the change or consolidation in advance. If such changes to the terms and conditions are material, an investment trust manager has to give at least two weeks' prior written notice to known unitholders and hold a vote on a written resolution on such change or consolidation, unless such consolidation has only a minor influence on the unitholders' interests.

If an investment trust manager intends to terminate a trust agreement, it has to notify the regulator of this intention in advance. An investment trust manager has to give at least two weeks' prior written notice to known unitholders and hold a vote on a written resolution on such termination, except in cases where it is truly unavoidable to terminate a trust agreement without sending a notice or except when otherwise the conditions prescribed in advance by the terms and conditions of the trust agreement are met.

If any change is made to items that have been registered with the regulator, an investment corporation has to notify these to the regulator within two weeks of said change.

If an investment corporation is extinguished as a result of a merger or is dissolved, it must notify the regulator to that effect within 30 days after this takes place.

If any change is intended to be made to a constitutional document of a foreign investment trust, the issuer must notify such change to the regulator in advance. If such change to a constitutional document is material, the issuer has to give at least two weeks' prior written notice to known unitholders. If the issuer intends to terminate a constitutional document, it has to notify the regulator of its intention in advance and give at least two weeks' prior written notice to known unitholders.

If any change is intended to be made to the items included in a notification in respect of a foreign investment corporation having been filed with the regulator, it must notify the regulator of its intention in advance. If a foreign investment corporation is dissolved as a result of bankruptcy or similar proceedings, or will be dissolved for another reason, it has to notify this to the regulator.

Collective investment schemes must follow the ongoing requirements as prescribed by the relevant governing law. For example, in the case of an investment limited partnership formed under the LPAI, if any change is made to items that have been registered with the regulator, the investment limited partnership must apply for registration of such change within two weeks of such change.

2.3.10 Investor Protection Rules

There is no regulation that sets a specific limitation on investors for a certain investment fund.

However, a Registered Financial Instruments Business Operator has to comply with the general principle of suitability in the marketing and selling of financial instruments to investors under the FIEA. Pursuant to this, it must determine whether it is acceptable to market and sell a particular financial instrument to targeted investors, considering their knowledge and experience of investing in financial instruments, their asset situation and their purpose of investment, and provide an explanation to the investors in a manner and to the extent necessary for them to understand it.

Prior to entering into a contract with an investor, a Registered Financial Instruments Business Operator must, in general, deliver a document to the investor containing an outline of such contract, charges and fees, and major risk factors associated with the contract.

Upon concluding a contract, a Registered Financial Instruments Business Operator must, in general, deliver a document containing an outline of such contract, charges and fees, and provide a method for allowing communications between the operator and the investor.

2.3.11 Approach of the Regulator

The Financial Services Agency of Japan (FSA) has authority over the administration of the FIEA, and responsibility for regulating the financial markets and financial institutions. The FSA delegates certain authorities to a local finance bureau of the Ministry of Finance, such as that of regulating Registered Financial Instruments Business Operators and disclosure obligations in respect of financial instruments.

There is no general limitation on access to the regulator, but it may take time to obtain its conclusions on matters that are innovative or unprecedented. In some cases, the regulator prefers to hold preliminary consultations prior to an official filing or application.

2.4 Operational Requirements

A Registered Investment Manager owes a general duty of sincerity and fairness to its clients and must work faithfully on behalf of its investors and carry out its investment management business with the due care of a prudent manager under the FIEA.

As part of this, the FIEA specifically prohibits a Registered Investment Manager from:

- conducting a transaction with itself or its offices;
- conducting a transaction between investment funds both of which are managed by it;
- conducting a transaction with the aim of benefitting itself or a third party;
- conducting a transaction that is detrimental to investors;
- purchasing or selling securities on its own account using information about a transaction that it has conducted as an investment;
- providing, or promising to provide, loss compensation or additional benefits to investors; or
- taking any other act deemed to be insufficient as a form of investor protection, harming the fairness of transactions, or causing a loss of confidence in the financial instruments business.

In addition, a Registered Investment Manager of collective investment schemes must manage invested assets separately from its own assets and other invested assets in the manner prescribed by the FIEA.

2.5 Fund Finance

While there is no restriction on borrowing in respect of an investment trust/corporation under the Investment Trusts Act, the rules of the ITAJ provide that a securities investment trust/corporation may borrow funds only to the extent that doing so is necessary for the purpose of providing funds for payment of redemption and distribution.

Collective investment schemes have no restrictions on borrowing.

2.6 Tax Regime

Taxation of Investment Funds

Investment trusts are generally exempted from Japanese taxation.

Investment corporations are subject to income tax, but distributions payable to investors can be included in tax deductible expenses if certain conditions are met, such as distributing an amount equal to more than 90% of profit available for dividend to investors.

Collective investment schemes are pass-through entities and are non-taxable at the investment fund level.

Taxation of Investors

For Japanese tax purposes, investment trusts are classified into public and corporate bond investment trusts and stock investment trusts. The former invest in public and corporate bonds, but may not invest in any stocks, shares or equities, while the latter comprise investment trusts other than public and corporate bond investment trusts.

There is no such classification for investment corporations, which are generally treated in the same way as stock investment trusts for tax purposes.

For individual investors, investment in a stock investment trust is treated the same as a direct investment in unlisted stocks for tax purposes. Ordinary distributions are subject to withholding taxes at the rate of 20.42% and, thereafter, to an aggregate taxation whereby tax is calculated in combination with other types of income by a final return. Special distributions are exempted from taxes because they are, in substance, a refund of capital.

Capital gains are subject to separate self-assessed taxation at the rate of 20.315%, whereby tax is calculated separately from other types of income by a final return.

Investment in a public and corporate bond investment trust is treated the same as a direct investment in public and corporate bonds for tax purposes. Ordinary distributions are subject to a withholding tax at a rate of 20.315%. Capital gains are subject to a separate self-assessed taxation at the rate of 20.315%.

For corporate investors, ordinary distributions and capital gains arising from an investment trust are subject to a withholding tax at a rate of 15.315%, which can be deducted from a corporate tax payable by the investors.

Collective investment schemes are transparent for Japanese tax purposes. Profits or losses of collective investment schemes are attributed directly to investors and recognised as their own profits or losses by them.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Traditionally, most publicly offered investment funds in Japan are securities investment trusts, while investment corporations are predominantly used as J-REITs. Many foreign investment trusts are also publicly offered in Japan, while foreign investment corporations such as SICAVs domiciled in Luxembourg are sometimes used.

Collective investment schemes are seldom publicly offered in Japan.

3.1.2 Common Process for Setting Up Investment Funds

The statutory establishment processes for publicly offered investment funds are the same as those for privately placed investment funds; please see **2.1.2 Common Process for Setting Up Investment Funds**. However, due to the rules of the ITAJ and the JSDA applicable to investment trusts/corporations and foreign investment trusts/corporations, respectively, publicly offered investment funds have to satisfy the detailed requirements provided for by them; please see **3.3.1 Regulatory Regime**.

3.1.3 Limited Liability

Please see **2.1.3 Limited Liability**.

3.1.4 Disclosure Requirements

In addition to the general disclosure requirements applicable to investment funds (please see **2.1.4 Disclosure Requirements**), an issuer of an investment fund who intends to conduct a public offering in Japan must file a securities registration statement in the form prescribed based on the types of securities enumerated by the FIEA prior to conducting solicitation in Japan. The SRS generally becomes effective 15 days after the filing, and thereafter an issuer can accept subscription orders placed by investors.

However, for an investment fund that is offered on a continuous basis, the SRS becomes effective on the day following the filing, on the condition that one year has elapsed since the previous SRS was filed. Accordingly, an investment fund can continue its public offering by filing a new SRS annually.

The SRS requires full disclosure of publicly offered investment funds, enabling investors to make reasonable investment decisions. For example, the SRS with respect to an investment trust must contain the following information:

- the terms and conditions of the public offering;
- the investment objective, fund structure, types of assets, management system, dividend policy, investment restrictions, risk factors, charges and costs, taxation, performance results, procedures of subscription and redemption, valuation of assets, term, and description of an investment trust manager, a trustee and related parties; and
- audited financial statements of an investment trust as well as an investment trust manager.

The SRS is filed through an electronic filing system called the Electronic Disclosure for Investors' NETwork (EDINET), and is made available for public inspection online.

If there is a change to material facts that must be stated on the SRS after it has been filed (including cases where new financial statements are prepared and an important lawsuit has been resolved), or if an issuer recognises there is an item on the SRS that needs amending, an amendment to the SRS must be filed.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

There is no restriction on types of investors in respect of public offered investment funds. General investors may apply for subscription, including a wide range of individual investors and institutional investors.

3.2.2 Legal Structures Used by Fund Managers

Please see **3.1.1 Fund Structures**.

3.2.3 Restrictions on Investors

Please see **3.2.1 Types of Investors in Retail Funds**.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

In general, a publicly offered securities investment trust must comply with the following requirements provided by the rules of the ITAJ.

- It may invest only in shares listed on a stock exchange and registered on an over-the-counter market established in a foreign country, and in unlisted shares or unregistered shares subject to disclosure obligations in accordance with the FIEA, the Companies Act of Japan or similar laws, or those issued in foreign countries that are deemed similar to these.
- It may invest in an aggregate amount of units/shares of investment funds up to 5% of its net assets. This limitation does not apply to fund-of-funds type securities investment trusts, but they must invest in multiple investment funds and comply with the credit risk limitations stated below.
- The amount of risk arising from derivative transactions calculated in a reasonable manner may not exceed its net asset value (the "derivative transaction limitation").
- Ratios of the exposure to a single entity to the total amount of net assets may not exceed 10% for each of the following categories, or 20% in total (the "credit risk limitation"):
  (a) shares and units/shares of investment trusts/corporations;
  (b) other securities and liabilities; and
  (c) derivative transactions.

A publicly offered foreign investment trust/corporation must comply with the following requirements provided by the rules of the JSDA:

- the total value of securities sold short shall not at any time exceed its net asset value;
- no more than 15% of the net assets may be invested in illiquid assets such as privately placed equity securities or unlisted securities, unless appropriate measures have been taken to ensure price transparency;
- any transactions that are contrary to the protection of unitholders or prejudicial to the proper management of assets, such as transactions made for the benefit of a manager or any third party, shall be prohibited;
- a manager shall not acquire shares of any one company if doing so would result in the total number of shares of such company held by all funds managed by a manager exceeding 50% of the total number of all issued and outstanding shares of such company;
- derivative transaction limitations; and
- credit risk limitations.

In addition, if an issuer of an investment trust/corporation intends to list their units/shares on a stock exchange (eg, ETF or J-REIT), they must apply for a listing examination from the relevant stock exchange. To be qualified as listed units/shares, they have to meet criteria for the listing examination provided by the securities listing regulations and related rules issued by the relevant stock exchange.

3.3.2 Requirements for Non-Local Service Providers

Please see **2.3.2 Requirements for Non-Local Service Providers**.

3.3.3 Local Regulatory Requirements for Non-Local Managers

Please see **2.3.3 Local Regulatory Requirements for Non-Local Managers**.

3.3.4 Regulatory Approval Process

Please see **2.3.4 Regulatory Approval Process**. An additional one to three months are required to prepare the SRS and a prospectus, depending on the complexity and risk character of an investment fund.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

The solicitation of securities before the filing of the SRS is strictly prohibited under the FIEA. Therefore, it is important to distinguish between the solicitation of securities and pre-marketing in a public offering. However, as it is difficult to draw a clear line between them, it is important to take all the relevant factors into account (please see **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**).

3.3.6 Rules Concerning Marketing of Retail Funds

An issuer must prepare a prospectus in connection with a public offering of an investment fund.

A prospectus in respect of an investment fund comprises a summary prospectus and a full prospectus. A summary prospectus must contain substantially material information, such as an outline of investment objectives and features, selected information on the investment trust manager, material risk factors, selected performance results and charges and costs in the case of an investment trust.

An issuer or distributor must deliver a summary prospectus to prospective investors before or at the same time as the sale. A full prospectus must contain almost the same information as the SRS, and an issuer or distributor must, upon request, deliver this to a prospective investor immediately.

3.3.7 Marketing of Retail Funds

Please see **3.3.3 Local Regulatory Requirements for Non-Local Managers**.

3.3.8 Marketing Authorisation/Notification Process

Please see **3.1.4 Disclosure Requirements**.

3.3.9 Post-Marketing Ongoing Requirements

An issuer of investment funds for which the SRS has been filed is subject to an ongoing disclosure obligation to file the annual securities report and semi-annual report every year within three months (or six months for an offshore investment funds) after the fiscal year end and the interim fiscal year end, respectively (where the fiscal period is six months or less, an issuer must file an annual securities report every six months).

An annual securities report with respect to an investment trust must contain the following information:

- investment objective, fund structure, types of assets, management system, dividend policy, investment restrictions, risk factors, charges and costs, taxation, performance results, procedures of subscription and redemption, valuation of assets, term, and description of

the investment trust manager, the trustee and related parties; and
- audited financial statements of the investment trust as well as the investment trust manager.

A semi-annual report with respect to an investment trust must contain the following information:

- performance results for a six-month period;
- a description of the investment trust manager; and
- unaudited interim financial statements of the investment trust and the latest financial statements of the investment trust manager.

The annual securities report and semi-annual report are filed through EDINET and made available for public inspection online.

In addition, an issuer must file an extraordinary report if a certain event occurs as prescribed by the law, including a change to a major investment fund-related corporation, a material change to basic policies, restrictions or dividend policies, a dissolution of the investment corporation or termination of the investment trust.

Furthermore, if units/shares of an investment trust/corporation are listed on a stock exchange, they are subject to timely disclosure obligations provided by the securities listing regulations and related rules issued by the relevant stock exchange. For example, an issuer of an exchange traded fund (ETF) listed on the Tokyo Stock Exchange must disclose details of secondary offerings, borrowing of funds, revision of terms and conditions of a trust agreement, cancellation of a trust agreement, or the merger or dissolution of an issuer immediately after the occurrence thereof.

3.3.10 Investor Protection Rules

If the SRS or a prospectus contains a false statement regarding a material fact, or omits a statement regarding a material fact that is required to be stated or is necessary to prevent the SRS or prospectus from being misleading, an issuer is liable for damages suffered by an investor, whether or not there is an absence of intent or negligence on the part of the issuer, unless it can be shown that the investor was aware of such false statement or such omission at the time of purchase. Furthermore, the directors of the issuer filing such SRS, or the distributors using such prospectus, are liable for damages suffered by an investor, except in cases where such directors or distributors can prove that they did not know or could not have known of such false statement or omission had they exercised reasonable care.

In addition, it is prohibited for any person to use a prospectus containing a false statement or omitting a necessary statement or to make a false or misleading representation in documents, in drawings, via audio media or by means other than the prospectus.

Apart from this, an issuer that has filed an SRS containing a false statement or misleading omission would be subject to criminal penalties and administrative fines.

3.3.11 Approach of the Regulator

Please see **2.3.11 Approach of the Regulator**.

3.4 Operational Requirements

Please see **2.4 Operational Requirements**.

3.5 Fund Finance

Please see **2.5 Fund Finance**.

A publicly offered foreign investment trust may borrow up to 10% of the net asset value.

3.6 Tax Regime

The taxation of publicly offered investment funds is basically the same as for privately placed investment funds.

Nonetheless, for individual investors, in respect of stock investment trusts, ordinary distributions are subject to a withholding tax at the rate of 20.315%; thereafter, the taxpayer may select an aggregate taxation, a separate self-assessed taxation or a separate taxation at source. If separate taxation at source is selected, the taxpayer's tax obligations are thereby fulfilled.

Capital gains are subject to a separate self-assessed taxation at the rate of 20.315%. In respect of public and corporate bond investment trusts, ordinary distributions are subject to a withholding tax at the rate of 20.315%; thereafter, the taxpayer may select a separate self-assessed taxation or a separate taxation at source. Capital gains are subject to a separate self-assessed taxation at the rate of 20.315%.

In respect of investment corporations, ordinary distributions are subject to a withholding tax at the rate of 20.315%; thereafter, the taxpayer may select an aggregate taxation, a separate self-assessed taxation or a separate taxation at source. Capital gains are subject to a separate self-assessed taxation at the rate of 20.315%.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Although there are no laws or regulations in Japan that prohibit an investment trust from investing in unlisted stocks, until recently there had been no investment trusts investing in unlisted stocks partly because the clear valuation method of unlisted stocks had not been established. In particular, it had been difficult for publicly offered investment trusts, which normally calculate the net asset value and allow investors to purchase and sell the units on a daily basis, to invest in illiquid unlisted stocks.

However, in December 2023, the government of Japan published the "Policy Plan for Promoting Japan as a Leading Asset Management Centre", with the aim of reforming Japan's asset management sector and asset ownership. As a part of this initiative, it is now required to activate the provision of growth funds to start-up companies, which is deemed essential for sustainable economic growth, through stock investment. In line with this, the rules of the ITAJ have been amended to make it possible for publicly offered investment trusts to invest in unlisted stocks in practice, in an attempt to facilitate the smooth provision of funds to unlisted companies, including start-up companies, and provide various investment opportunities to investors.

Pursuant to the amended ITAJ rules, in general, an investment trust may invest up to 15% of its total net assets in unlisted stocks. Furthermore, it may invest more than 15% in them, provided that, from the viewpoint of investor protection, it:

- takes measures to ensure liquidity and consider equality among unitholders and, there-

after, includes such measures in a prospectus and other materials; and
- discloses the risks associated with the investment in unlisted stocks in the prospectus and other materials.

In addition, investable unlisted stocks must satisfy certain requirements, such as being issued by a company of which the financial statements are audited by a certified public accountant or audit firm and an unqualified audit report is issued on them. Notwithstanding this requirement, in the case where unlisted stocks are indirectly held through investment trusts or other entities and if such investment trusts or other entities are subject to audit, the audit requirement applicable to the underlying unlisted stocks can be omitted.

Furthermore, in investing in unlisted stocks, an investment trust is required to examine the status of ensuring sound management of the company issuing such unlisted stocks and other matters.

Trends and Developments

Contributed by:
Yasuzo Takeno, Ken Miura and Nobuharu Onishi
Mori Hamada & Matsumoto

Mori Hamada & Matsumoto is one of the largest full-service Tokyo-headquartered international law firms. A significant proportion of its work is international in nature, representing clients in cross-border transactions, litigation and other dispute resolution proceedings. MHM has more than 700 lawyers and other professionals, and more than 600 support staff. The firm's senior lawyers include highly respected practitioners and leaders in the Japanese and international legal community, including prominent law professors at the University of Tokyo and a former Prosecutor-General of the Public Prosecutors Office. MHM is lauded by clients and legal professionals in the following practice areas: asset management/investment funds, M&A, capital markets, securitisations, private equity, infrastructure/energy, insolvency/restructuring, antitrust and competition. The firm has domestic offices in Yokohama, Takamatsu, Fukuoka, Osaka, Nagoya and Sapporo, and also has a strong presence across Asia, with offices in Beijing, Shanghai, Singapore, Yangon, Bangkok, Ho Chi Minh City, Hanoi and Jakarta, as well as New York.

Authors

Yasuzo Takeno is a partner at MHM and has extensive experience in advising domestic and foreign investment managers and investment funds businesses, including on structuring public offerings and private placements of offshore investment funds in Japan. He has advised issuers of foreign investment trusts established in Luxembourg, Ireland, the Cayman Islands and other jurisdictions on legal and execution issues where they offer their units in Japan, either publicly or privately. Yasuzo advises on the day-to-day management of investment fund businesses; his practice also spans corporate finance activities and financial regulation. He is a member of the Daini Tokyo Bar Association, the International Bar Association and the Inter-Pacific Bar Association.

Ken Miura is a leading partner of MHM's asset management/ investment funds and capital markets practice groups. He has advised on a number of historic deals, such as the introduction of US mutual funds in Japan for public offering, the launch of the first domestic exchange-traded fund in Japan, the establishment of principal-protected funds for the retail market and the creation of pension funds with alternative investment strategies. He also advises on various capital market transactions, including eurobond issues, global offerings of debt and equity securities, and the secondary sale of eurobonds to Japanese retail investors. Ken is a member of the Daini Tokyo Bar Association.

Nobuharu Onishi is a partner at MHM and is active in the fields of asset management, investment funds, investment companies, capital markets and financial regulations. He acts for an international clientele, with a focus on the USA, the EU, Hong Kong and the Cayman Islands. He was advising the Financial Services Agency and the Japan Securities Dealers' Association when new foreign investment funds regulations concerning derivative transactions and diversification requirements were introduced, and has assisted the JSDA in prescribing the new regulations in accordance with the Asia Region Funds Passport's Memorandum of Co-operation. Nobuharu is a member of the Daini Tokyo Bar Association and the International Bar Association.

Mori Hamada & Matsumoto

Marunouchi Park Building
2-6-1 Marunouchi, Chiyoda-ku
Tokyo 100-8222
Japan

Tel: +81 3 6212 8330
Fax: +81 3 6212 8230
Email: info@morihamada.com
Web: www.morihamada.com

MORI HAMADA

Contributed by: Yasuzo Takeno, Ken Miura and Nobuharu Onishi, **Mori Hamada & Matsumoto**

Growing Demand for Alternative Investment Funds in Japan: From Private Placements to Public Offerings

Introduction

State of the investment funds market

For a long time in Japan, investment funds for retail investors only invested in traditional assets and their derivatives, while alternative investment funds were only marketed to institutional investors. However, in recent years, this trend has begun to change. This article will discuss these changing trends, but will first briefly describe the basic information of investment funds in Japan.

In Japan, investment funds are one of the most popular financial instruments for both institutional and retail investors.

Types of private placement and public offering

Under the laws of Japan, units/shares of investment funds may be offered by way of public offering or private placement. In a private placement, an issuer may be exempted from certain disclosure requirements that apply to public offerings.

There are basically three different types of private placement exemption:

- Private Placement to a Small Number of Persons;
- Private Placement to Professional Investors; and
- Private Placement to Qualified Institutional Investors.

In general, a Private Placement to a Small Number of Persons focuses on the number of offerees, while Private Placements to Professional Investors and Qualified Institutional Investors focus on the offerees' qualification.

Fund structures

According to the laws of Japan, investment funds are generally divided into three different categories:

- investment trusts;
- investment companies; and
- limited partnerships.

The investment trust (sometimes referred to as a contractual type investment fund) is one of the most popular investment funds for Japanese investors. In fact, numerous investment trusts are established in Japan every year, and units of these investment trusts are actively offered/sold to Japanese investors by securities companies and banks.

It should be noted that not only investment funds established in Japan but also investment funds established outside Japan (such as an FCP in Luxembourg or a unit trust in the Cayman Islands) are offered to investors in Japan, and a significant amount of money is invested into those foreign investment funds from Japan. According to statistical data released by the Japan Securities Dealers' Association (JSDA) on 13 June 2024, the total net asset value of publicly offered investment funds established outside Japan (for Japanese domestic investors) as of the end of March 2024 was JPY8,489.8 billion.

In Japan, an investment company (sometimes referred to as a corporate type investment fund) is mainly used in the context of REITs. In other words, an investment company established in Japan is not generally utilised for the purpose of investment into securities (such as equities or bonds). However, it is also true that some securities firms actively offer various types of SICAVs established in Luxembourg to Japanese retail investors.

A limited partnership (sometimes referred to as a partnership type investment fund) is mainly utilised for the purpose of private equity investments and infrastructure investments. This type of investment fund is not so common for Japanese retail investors, and most investors are institutional. As with other types of investment funds, not only Japanese domestic funds but also limited partnerships established outside Japan are offered in Japan. A certain number of limited partnerships established outside Japan were recently introduced for wealthy individuals through feeder vehicles such as a Cayman unit trust on a private placement basis.

Alternative investment funds

For a long time, most of the investment funds sold to retail investors only invested in traditional assets and their derivatives, while alternative investment funds were sold only to institutional investors in Japan. There are several reasons for this, but one of the most important is that alternative investment funds are considered to carry a greater degree of risk than traditional investment funds, and should therefore only be sold to institutional investors with a high risk tolerance.

However, especially in an environment of extremely low interest rates in Japan, the potential for greater returns of alternative investments is very attractive not only to institutional investors but also to high net worth individuals, and in the current situation where it is difficult to make a profit by investing in traditional assets such as bonds, more and more wealthy individuals are willing to take risks and invest in potentially profitable products.

For this reason, the public offering of alternative investment funds targeted specifically at high net worth individuals has begun to be considered by distributors and asset managers in Japan; in fact, a non-listed US REIT was publicly offered in Japan through a Cayman unit trust in 2022. This trend has spread not only to real estate investment, but also to private equity and private credit. In 2023 and 2024, Cayman-domiciled mutual funds that substantially invest in these asset classes were publicly offered in Japan.

Generally, investment funds solicited in Japan do not invest directly in these alternative assets but rather in alternative investment funds (ie, in the form of a fund of funds) or performance-linked notes whose performance is linked to alternative investments.

Considerations for investing in alternative investment funds

It may be true that alternative investment funds offer investors potentially large profit opportunities. However, it is also true that alternative investment funds have several considerations that are generally not found in traditional investment funds, including:

- higher fees;
- significant initial investment requirements;
- low liquidity; and
- low transparency.

As discussed below, publicly offered funds are subject to strict investment restrictions, but it is possible under the laws of Japan to publicly offer alternative investment funds, provided that the key characteristics of alternative investment funds are disclosed in an appropriate and sufficient manner to enable investors to make accurate investment decisions.

Investment restrictions

Publicly offered non-Japanese investment trusts (such as an FCP in Luxembourg or a unit trust in the Cayman Islands) and investment companies (such as SICAVs established in Luxembourg) are subject to certain investment restrictions under the rule of the JSDA, which include but are not limited to the following (note that there is no statutory investment restriction applicable to privately placed non-Japanese investment funds):

- short sale (applicable only to non-Japanese investment trusts) – the total market value of securities sold short for the account of such fund shall not exceed its net asset value;
- borrowings (applicable only to non-Japanese investment trusts) – borrowing for the account of such funds shall not exceed 10% of its net asset value;
- derivative transactions – the global risk amount of outstanding derivative transactions and other similar transactions entered into for the account of a non-Japanese fund, which is to be calculated in accordance with a reasonable method, shall not exceed a certain ratio of their respective net asset value;
- credit risk – credit exposures to any single issuer of portfolio securities or counterparty of derivative transactions shall be managed and administered in accordance with a reasonable method;
- voting rights of a single issuer – acquiring the shares of any one company is not allowed if such acquisition would result in the total number of shares of such company carrying voting rights held by either (a) all foreign investment trusts managed by the same manager or (b) a foreign investment company exceeding 50% of the total number of all issued and outstanding shares of such company carrying voting rights;
- transparency requirement – this is applicable only to non-Japanese investment trusts, which shall not acquire any investment that is not listed on an exchange or not readily realisable, such as privately placed shares, unlisted shares or real estate if, as a result thereof, the total value of all such investments held by the non-Japanese investment trust would immediately following such acquisition exceed 15% of the latest available net asset value, provided that this restriction shall not prevent any acquisition of an investment where the method of valuation of such investment is clearly disclosed in offering documents;
- acquisition of shares issued by itself – this is applicable only to non-Japanese investment companies, which shall not acquire shares issued by themselves; and
- inappropriate transactions – non-Japanese investment trusts and investment companies shall not enter into inappropriate transactions that are detrimental to the investors or would be contrary to the proper management of the assets of those funds, including, without limitation, transactions that are intended to benefit the asset manager or any third parties other than investors.

As mentioned above, the investment targets of alternative investment funds (eg, real estate, private equity, private credit) are illiquid and cannot be readily realisable. Therefore, under the transparency requirement, the method of valuation of such investment must be clearly disclosed in offering documents in order for alternative investment funds to be publicly offered in Japan.

Having said that, it is difficult to precisely calculate the value of the investment targets (ultimate underlying investments) of alternative investment funds, and there is always a risk that the calculated value and the actual sale price may differ significantly. Thus, it is necessary to describe this consideration as one of the risk factors in offering documents. Needless to say, it is also necessary to alert investors to the risk that investments in alternative investment funds cannot be easily redeemed.

Investor protection rules

There are no rules in Japan that specify certain classes of investors as being inappropriate to invest in certain types of funds.

However, the laws of Japan require a financial instruments business operator (such as distributors in Japan) to ensure that its issuance of a solicitation in connection with an act that constitutes a financial instruments transaction which is found to be inappropriate in light of customer knowledge, customer experience, the state of customer assets or the purpose for which a financial instruments transaction contract is concluded does not result in nor is likely to result in insufficient investor protection.

Therefore, even if the required procedures have been completed, it does not mean that the alternative investment fund can be sold to anyone.

Tax regime for investment trusts

Under the Corporation Tax Act, Collective Investment Trusts are treated as tax-exempt trusts.

The following investment trusts are categorised as Collective Investment Trusts under the Corporation Tax Act:

- Securities Investment Trusts (regardless of whether they are publicly offered or privately placed);
- investment trusts publicly offered in Japan; and
- Foreign Investment Trusts.

Collective Investment Trusts are not treated as pass-through entities but they are tax-exempt, so are not taxed in respect of capital gains and income paid to them. Investors in a Collective Investment Trust are subject to the relevant withholding taxes in respect of profit distribution.

Tax regime for investment companies

Taxation is imposed on investment companies at the fund level. However, if certain conditions are fulfilled (eg, more than 90% of distributable profits must be distributed to investors), dividends paid to investors may be deducted for Japanese corporation tax purposes. Investors in investment companies are subject to the relevant withholding taxes in respect of profit distribution.

Tax regime for limited partnerships

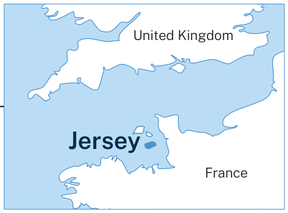
Limited partnerships are pass-through entities for Japanese tax purposes, with taxes being levied on the investors in the fund rather than on the fund itself. Non-resident investors (both individuals and corporates) are subject to relevant withholding taxes in respect of profit distribution, whereas resident investors are not subject to withholding taxes.

Summary

As described, the appetite for alternative investment funds focusing on real estate, private equity or private credit has been increasing in the retail market in Japan, and this trend is likely to continue for the foreseeable future.

Investors are certainly attracted by the potentially high return that alternative investments can provide, which is difficult to achieve through investments in traditional assets. However, it should be emphasised that an investment in alternative investment funds involves a higher degree of risk than an investment in traditional investment funds, and therefore it is important to strive to provide investors with accurate information on this point. For sustainable growth of the Japanese investment fund industry, there should be a market situation where Japanese investors are provided with sufficient and accurate information of the funds on this point to enable them to make their own investment decisions and invest in suitable funds from among various investment funds, including alternative investment funds.

JERSEY



Law and Practice

Contributed by:
Nienke Malan and Christopher Griffin
Carey Olsen

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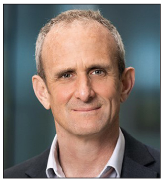
Carey Olsen is a leading offshore law firm that advises financial institutions, corporations and private clients on Bermuda, British Virgin Islands, Cayman Islands, Guernsey and Jersey law from a network of nine international offices. Its clients include global financial institutions, investment funds, private equity houses, multinational corporations, public organisations, sovereign wealth funds, ultra-high net worth individuals, family offices, directors, trustees and private clients. The firm works alongside all the major onshore law firms, accountancy firms and insolvency practitioners on corporate transactions and matters involving its jurisdictions. Carey Olsen Jersey is the leading legal adviser to investment funds domiciled in Jersey, advising 679 funds domiciled there – which represents over 40% of the market by total number of funds.

Authors

Nienke Malan is a partner in Carey Olsen Jersey's corporate team and a Jersey qualified lawyer with over a decade of experience in investment funds, corporate and international commercial matters. She supports experienced and emerging fund managers in achieving their goals through a client-centric and practical solution-driven approach, and advises on the full spectrum of generalist funds and sector funds, including real estate, private equity, buyout, venture capital, infrastructure, housing, technology, healthcare and impact funds. Having practised in South Africa, New York and Jersey, Nienke has worked with global clients across multiple asset classes, and cultivates lasting relationships with her clients.



Christopher Griffin is a partner in Carey Olsen Jersey's corporate team. He has broad experience of both general international corporate and funds work, with particular expertise in private equity and hedge and digital asset funds, having spent ten years as a corporate and funds lawyer in London. Chris advises on all aspects of fund and corporate transactions, including the legal and regulatory aspects of fund launches, as well as joint ventures. He also has considerable experience in dealing with the Jersey Financial Services Commission in navigating investment vehicles through the Jersey regulatory approval process, as part of the Jersey funds team. Chris also spearheads Carey Olsen's digital asset practice, having advised on a series of token issuances, digital asset funds and exchanges.

Carey Olsen Jersey LLP

Carey Olsen Jersey LLP
47 Esplanade
St Helier
Jersey JE1 0BD

Tel: +44 0153 4888 900
Fax: +44 0153 4887 755
Email: jerseyco@careyolsen.com
Web: www.careyolsen.com

1. Market Overview

1.1 State of the Market

Jersey is one of the world's major international finance centres. The expertise that Jersey offers extends across all asset classes, with recent growth being particularly focused on alternative asset classes. Jersey is widely considered to be a key player in the world of domiciling, administering and managing various types of investment funds. This growth is underpinned by Jersey's tax neutrality and a legal framework that provides certainty to both investors and managers.

The Jersey government's determination to encourage high-quality business to the island, coupled with Jersey's comprehensive and forward-thinking legal infrastructure, has been pivotal in driving investor confidence and capital inflows into the island. Over the past year, the market has shown remarkable resilience and adaptability, cementing Jersey's status as a premier choice for fund domiciliation and management.

Jersey caters to a wide spectrum of investor preferences, and regulatory versatility is a cornerstone of Jersey's appeal. From highly regulated retail funds that may be offered to the general public to those with minimal supervision for sophisticated investors, the Jersey Financial Services Commission (JFSC) plays a vital role, authorising and overseeing investment funds with an ethos of protecting investors while promoting competition and innovation.

The Jersey Private Fund (JPF), with a 48-hour regulatory consent turnaround, continues to be extremely attractive, offering a streamlined and cost-effective solution for managers targeting "professional investors" or investors who invest at least GBP250,000 (or the currency equivalent). Since their inception in 2017, JPFs have gained popularity for their quick set-up process and operational flexibility, meeting the needs of both emerging managers and established institutions. As an additional benefit, the JPF regime provides an exemption to the Financial Services (Jersey) Law 1998 (FSJL), which permits SPV managers, general partners and other service providers to act for JPFs without becoming regulated in Jersey.

Other popular fund types in Jersey include the notification-only Jersey Unregulated Eligible Investor Fund ("Notification-Only Fund") and Jersey Expert Fund, which may be offered to an unlimited number of qualifying investors who invest a minimum of USD1million (in the case of a Notification-Only Fund) or USD100,000 (in the case of an Expert Fund) or who meet certain other criteria.

Jersey has a unique relationship with both the UK and the EU. It has been treated by the EU as a "third country" for financial services purposes for many years, and since the introduction of the Alternative Investment Funds Managers Directive (AIFMD) has proven a popular location for managers and funds wishing to access EU/EEA markets using private placement routes.

Jersey's strategy in relation to the AIFMD and, more recently, the UK AIFM Regulations, is to have the correct frameworks in place to continue to provide fund establishment, management and administration services on a "business as usual" basis. Jersey has achieved this by placing an AIFMD/UK AIFM Regulations "overlay" on existing regulatory frameworks such that a Jersey fund need only comply with AIFMD/UK AIFM Regulations to the extent that it is necessary and without imposing any additional Jersey-specific reporting or other requirements.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Alternative investment funds in Jersey are typically structured as companies (including protected cell and incorporated cell companies), limited partnerships or unit trusts, each offering distinct advantages tailored to specific investment strategies and investor requirements.

Company

Overview

A Jersey company has its own separate legal personality and may sue, and be sued, in its own name.

Advantages

The Companies (Jersey) Law 1991 is based on familiar UK company law but with certain enhancements that allow for a more flexible and practical regime. There are a number of advantages to Jersey companies, including as follows.

- The law provides for a flexible capital maintenance regime and, subject to the board giving a 12-month forward-looking cash-flow-based solvency test, a Jersey company may fund a distribution from any source other than its nominal capital account (in the case of a company whose shares have a nominal value) or any capital redemption reserve. This means a Jersey company may still be able to make distributions when it has accumulated losses (including where it has a negative profit and loss account).
- There is no requirement for distributable profits in order to fund a repurchase or redemption of shares out of a non-capital account, and there is no requirement for available profits in order to fund a repurchase or redemption out of capital; subject to a solvency statement requirement, shares can be repurchased out of any company account (including capital accounts).
- A private company is not required to appoint an auditor or file its accounts.
- Jersey does not levy stamp duty or any equivalent transfer tax on transfers of shares (subject to limited exceptions in respect of local property).

Interests

A Jersey company issues shares, which can consist of different classes of shares with different rights attached to each class. Investors usually hold redeemable participating shares, whereas the manager holds non-redeemable shares.

Types

In addition to private and public, par value and no-par value limited companies, Jersey also offers two types of cell companies, namely:

- protected cell companies – the protected cell company and its protected cells together form a single company, but the assets of each are legally segregated; and
- incorporated cell companies – each cell is a separate company in its own right.

Companies are used by open-ended funds, including hedge funds, and are often established as limited companies; it is a requirement that Listed Funds be structured as companies.

Cell company structures are popular for umbrella funds, as they enable multiple cells to be created with administrative ease and minimal cost while enabling each cell to be ring-fenced for liability purposes. The cells may have different capital structures, boards of directors and articles of association, but must have the same registered office and company secretary.

Limited Partnership

Overview

The Jersey limited partnership is familiar to investors worldwide and usually comprises one or more general partners, who are jointly and severally liable for the partnership's debts, and one or more limited partners, who are only liable to the partnership to the extent of their agreed contribution.

Advantages

The main advantages of a Jersey limited partnership are as follows:

- treated as transparent for UK tax purposes;
- publicly available information does not include the identity of the limited partners or the limited partnership agreement (LPA) and therefore confidentiality is preserved;
- extremely flexible in respect of the commercial terms that can be provided for;
- no limit on the number of limited partners which can be admitted, subject to regulatory restrictions;
- Jersey law contains a helpful list of "safe harbours" which allows the limited partner a greater degree of involvement in the management of the limited partnership than some other jurisdictions, without them losing their limited liability; and
- the legislation, regulation and policy governing this area are subject to regular review and updated to maintain Jersey's international reputation and competitive advantage.

Interests

Investors hold limited partnership interests, and different classes or series of limited partnership interests are possible.

Types

A limited partnership can be established as any of the following:

- limited partnership (in the traditional sense, similar to an English limited partnership) established under the Limited Partnerships (Jersey) Law 1994;

- separate limited partnership under the Separate Limited Partnerships (Jersey) Law 2011, which has separate legal personality and is therefore similar to a Scottish limited partnership;
- incorporated limited partnership under the Incorporated Limited Partnerships (Jersey) Law 2011, which has separate legal personality and is a body corporate; and
- limited liability partnership (LLP) under the Limited Liability Partnerships (Jersey) Law 2017, whereby a partner of the LLP is generally not liable for the LLP's debts or losses (including those caused by another partner).

Jersey limited partnerships are commonly utilised by fund managers for closed-ended funds, particularly private equity, venture capital, private credit and real estate funds. Separate limited partnerships are also used for closed-ended funds (particularly for "fund of fund" vehicles) and carried interest vehicles.

Unit Trusts

Overview

A unit trust has no separate legal personality and is constituted by a trust instrument entered into by the trustee(s) and the manager, if one has been appointed.

Advantages

Jersey unit trusts are popular for the following reasons:

- easy and quick to establish;
- extremely flexible in respect of the commercial terms that can be provided for;
- can be structured to be treated as transparent for UK tax purposes;
- publicly available information does not include the identity of the unitholders or the trust instrument and therefore confidentiality is preserved; and
- no limit on the number of unitholders which can be admitted, subject to regulatory restrictions.

Interests

Investors are issued units, and different classes or series of units are possible.

Jersey property unit trusts (JPUTs) remain a popular structure for real estate funds. Unit trusts can be used for any regulatory category and, in the context of retail funds, can be structured as open-ended unclassified collective investment funds (OCIFs).

Limited Liability Companies (LLCs)

Overview

The Jersey limited liability company was recently introduced, and combines the limited liability protection of a company with the constitutional flexibility and privacy of a partnership, while enabling a choice between the management structure and tax treatment of both. An LLC consists of one or more members who are bound, together with a manager (if any), by an LLC agreement.

Interests

Investors hold an "LLC Interest".

Advantages

The LLC will be familiar to US investors and has the following additional advantages:

- the LLC agreement is not publicly fileable;
- the agreed LLC agreement can supersede statutory default positions – for example, all debts of the LLC will lie solely with the LLC, unless the members agree otherwise;

- no limit on the number of members which can be admitted, subject to regulatory restrictions; and
- treated as tax-transparent, but able to elect to be a body corporate.

An LLC can be established as a JPF, but is more likely to be used as the general partner, fund manager, carried interest recipient or holding vehicle.

2.1.2 Common Process for Setting Up Investment Funds

Regulatory Categories

The key features of each main regulatory category of Jersey fund are set out below, including (where relevant) indicative application timescales. The fund type which is most suitable for a promoter will depend largely upon commercial factors, such as the types of investors sought and the level of flexibility required.

All Jersey funds (other than Notification-Only Funds) are eligible to be marketed into the European Union and European Economic Area (EU/EEA) in accordance with the AIFMD through individual EU member states' national private placement regimes (NPPRs) and (once available) through the passporting regime. Jersey funds with a Jersey manager that are not actively marketed into the EU/EEA fall outside the scope of the AIFMD.

Jersey Private Funds (JPFs)

The JPF is quick to establish, flexible and cost-efficient, and has minimal regulatory requirements for funds with 50 investors or fewer. The key features of a JPF are as follows.

- Maximum of 50 investors at any time and a maximum of 50 initial offers. The JPF may not be listed on a stock exchange.
- Investors must qualify as "professional" investors and/or make an initial investment of at least GBP250,000 (or currency equivalent), and sign a simple investment warning (usually included in the subscription document).
- No limit on fund size.
- No investment or borrowing restrictions.
- May be open or closed for redemptions by investors.
- No need for Jersey directors or Jersey service providers, other than a Jersey regulated "designated service provider" (DSP) who must be appointed to ensure compliance with the necessary criteria and applicable anti-money laundering legislation, to carry out due diligence on the promoter and to file an annual compliance statement.
- Jersey SPVs can be established to act as service providers (such as a general partner, trustee or investment manager/adviser) and are generally not required to be regulated.
- "Fast track" approval as indicated below (self-certification by the fund administrator).

The following applies for establishing a JPF without active EU/EEA marketing:

- 48-hour regulatory approval following an online application by the DSP;
- no requirement to prepare an offering memorandum;
- no need for Jersey directors or service providers, and no audit requirement; and
- the fund is not regulated by the JFSC on an ongoing basis.

The following applies for establishing a JPF with EU/EEA marketing (where there is a sub-threshold Jersey AIFM):

- ten-day regulatory approval for an AIF certificate;

- no requirement for Jersey directors or service-providers and no audit requirement;
- for a Jersey AIFM, a simple JFSC consent is required (there is no ongoing regulation); and
- minimal requirements will apply under the AIF Code.

The following applies for establishing a JPF with EU/EEA marketing (where the Jersey AIFM is not sub-threshold).

- Ten-day regulatory approval for an AIF certificate, plus JFSC personal questionnaire review process (four to six weeks) for directors and 10% beneficial owners of the Jersey AIFM (if applicable).
- Two Jersey directors required.
- Where the AIFM is a Jersey entity (such as a general partner, trustee or external manager), it must obtain a licence under the JFSC's AIFMD regime.
- An "AIF Certificate" is needed to permit EU/EEA marketing. Ongoing JFSC regulation is limited to compliance with the limited applicable AIFMD provisions.
- The JFSC assesses the suitability of the fund's promoter having regard to its track record and relevant experience, reputation, financial resources and spread of ultimate ownership, in light of the level of sophistication of the target investor group.
- Audit and certain regulatory and investor disclosure requirements will also apply.
- No ongoing regulation (except limited applicable AIFMD rules).

Regulated Public Funds

Public funds are governed by Jersey's collective investment funds law and are suitable for funds with more than 50 investors or where a regulated product is needed. They include Expert Funds, Listed Funds and Eligible Investor Funds (each, a "Regulated Fund"). The JFSC has published a Code of Practice which includes guides (together, the "JFSC Guides") in relation to Jersey Regulated Funds, setting out the structural and ongoing requirements applicable to the relevant fund type.

The key features of a Regulated Fund are as follows:

- published three-day approval timeframe following completed application (ten days for a new "special purpose" service provider company);
- no investment or borrowing restrictions;
- suitable for EU/EEA marketing;
- unlimited number of investors;
- relatively light-touch regulatory approach;
- audit requirement;
- the offer document must comply with certain content requirements (please see **2.1.4 Disclosure Requirements**) and investors must sign a prescribed investment warning; and
- derogations from the relevant JFSC Guide may be sought on a case-by-case basis.

Jersey service providers to a Regulated Fund will need to hold a licence to conduct the relevant class(es) of fund services business ("FSB Licence"). Accordingly, if any SPV service providers, such as a general partner or manager, will be established to act for the fund, an FSB Licence will need to be sought for each such entity. Such service providers are also required to comply with the Code of Practice issued by the JFSC that covers fund services businesses and AIFs (including their AIFMs and depositaries, where these are Jersey entities).

Expert Funds

The Expert Fund is attractive for non-retail schemes, whether hedge funds, private equity funds or other schemes aimed at "Expert Investors". An Expert Fund can be established quickly and cost-effectively, and must comply with the Jersey Expert Fund Guide (the "EF Guide"). The JFSC does not need to review the fund structure, documentation or the promoter. Instead, the fund administrator certifies to the JFSC that the fund complies with the EF Guide and, once the certification and the fund's offer document are filed, the JFSC aims for a three-day turnaround on the application for approval. The EF Guide provides fund promoters with certainty, efficiency and cost-effectiveness in the establishment of a new fund. The key features of an Expert Fund are as follows.

- Open only to those investing at least USD100,000 or who otherwise qualify as Expert Investors (that is, investors with a net worth of more than USD1 million (excluding their principal place of residence) or who are in the business of buying or selling investments). Investors must sign a prescribed form of investment warning (usually contained in the subscription document).
- Discretionary investment managers may invest on behalf of non-Expert Investors, provided they are satisfied that the investment is suitable for them and they are able to bear the economic consequences of the investment.
- May be open-ended (open for redemption at the option of investors) or closed-ended (no absolute investor right to redeem).
- At least two Jersey resident directors with appropriate experience must be appointed to the fund board (or, if applicable, the board of the general partner or trustee).
- A licensed Jersey manager or administrator which has two Jersey-resident directors with appropriate experience and staff and a physical presence in Jersey is required (unless the fund is a unit trust with a Jersey trustee).
- A Jersey custodian is needed if the fund is open-ended (or an international prime broker, in the case of a hedge fund).
- The offer document must set out all material information in respect of the fund.
- The fund must be audited.
- The investment manager/adviser must be:
  (a) established in an OECD member or any other state or jurisdiction with which the JFSC has entered into a memorandum of understanding;
  (b) regulated in its home jurisdiction (or, if not required to be so regulated, approved by the JFSC); and
  (c) without convictions or disciplinary sanctions, solvent, and experienced in using similar investment strategies to those adopted by the fund.
- If the investment manager/adviser does not meet the above requirements, it may approach the JFSC on a case-by-case basis. Of course, if permission is granted, absent any material change, the investment manager/adviser will not need specific approval to establish further Expert Funds.
- An investment manager/adviser is not required for certain self-managed funds, such as direct real estate or feeder funds.
- There are no investment or borrowing restrictions imposed on the fund, nor is there any limitation on the number of investors the fund may have.
- The EF Guide aims to make a "safe harbour" available to the majority of non-retail funds. On occasion, where derogations from the EF Guide are required, these are considered on an expedited basis.
- Ongoing requirements are limited. Future changes to the fund generally do not require regulatory approval unless they are contrary

to the EF Guide or there is a change to the fund's directors or service providers.
- The fund may be marketed into the EU/EEA in accordance with the AIFMD through individual EU member states' NPPRs (and, when available, third-country passporting).

Listed Funds

A Listed Fund must comply with the Jersey Listed Fund Guide (the "LF Guide"). The LF Guide does not place any restrictions or qualification criteria on who can invest in a Listed Fund, and provides certainty to those wishing to establish a Listed Fund in a quick and cost-effective manner. A Listed Fund is established on certification by the fund administrator that the fund complies with the criteria set out in the LF Guide. The JFSC issues the relevant certificate on receipt of the certification and the fund's offer document. As a result, a Listed Fund can be established in Jersey within three days. There is no minimum investment requirement. The key features of a Listed Fund are as follows.

- The fund must be a closed-ended Jersey company (no absolute investor right to redeem).
- The fund's offering document must carry a clear investment warning and contain all information necessary for potential investors to make an informed decision.
- At least two Jersey resident directors with appropriate experience must be appointed to the fund's board, including the chair. A majority of the board must be independent (in particular, an independent director should not be an employee (or recent employee) of the manager, investment manager or any of their associates).
- The fund must be listed on an exchange or market recognised by the JFSC. The list of pre-approved exchanges is numerous and global in scope, and includes all exchanges upon which listings are ordinarily sought, including the London Stock Exchange (the Main Market, AIM and the SFM), NYSE, NASDAQ, HKEx, Euronext, Johannesburg Stock Exchange and The International Stock Exchange (TISE).
- The fund's investment manager/adviser must be of good standing, established and regulated (if appropriate) in an OECD member state or a jurisdiction with which the JFSC has a memorandum of understanding.
- A licensed Jersey manager or administrator which has two Jersey-resident directors with appropriate experience and staff and a physical presence in Jersey is required.
- Adequate arrangements must be made for the safe custody of the fund's property, but there is no requirement to appoint a custodian.
- The fund must be audited.
- The fund may be marketed into the EU/EEA in accordance with the AIFMD through NPPRs (and, when available, third-country passporting).

The JFSC understands that some investment managers/advisers may not be regulated because the type of activity they undertake is not regulated in their home jurisdiction: real property investment management being one example. In such cases, the investment manager will remain eligible for the fast-track authorisation process provided it is:

- the subsidiary of an entity that is regulated in relation to managing or advising on investment funds in its home jurisdiction;
- an entity or the subsidiary of an entity with a market capitalisation of above USD500 million; or

- a manager with a trading record of at least five years or whose principal persons can demonstrate relevant experience or qualifications.

If an investment manager/adviser does not meet these requirements, it may approach the JFSC on a case-by-case basis. Of course, if permission is granted, in the absence of any material change, the investment manager/adviser will not need specific approval to establish further Listed Funds. An investment manager/adviser is not required for certain self-managed funds, such as direct real estate or feeder funds.

Eligible Investor Funds

The structural, authorisation and ongoing regulatory requirements of the Jersey Eligible Investor Fund is similar to those for the Expert Fund, save that there is a higher threshold for qualifying as an "Eligible Investor" than as an "Expert Investor". Like the Expert Fund, the Eligible Investor Fund is used for non-retail schemes (including hedge funds, private equity funds and other schemes aimed at Eligible Investors) and can be established quickly and cost-effectively. The following applies for this type of fund.

- Must be an AIF and marketed into at least one EU/EEA country for the purposes of the AIFMD.
- Eligible Investors only. This falls under any one of 11 categories, including an investor of USD1 million or more, investors with a net worth of more than USD10 million (excluding their principal place of residence), and those whose ordinary business or professional activity includes dealing in, managing, underwriting or giving advice on investments (same as for Notification-Only Funds, below).
- Reduced requirements apply to the fund's offering document, given the sophisticated nature of investors in such funds.
- Open or closed for redemptions by investors.
- The regime expressly recognises that a discretionary investment manager may make investments on behalf of investors who do not qualify as Eligible Investors, provided it is satisfied that the investment is suitable for the underlying investors and they are able to bear the economic consequences of the investment.
- The fund may be marketed into the EU/EEA in accordance with the AIFMD through NPPRs (and, when available, third-country passporting).

Notification-Only Funds

This fund is highly flexible and is a low-cost structure ideal for sophisticated investors where the fund will not be marketed into the EU/EEA. A Notification-Only Fund may be open/closed-ended and is restricted to sophisticated investors. The JFSC Guides do not apply to Notification-Only Funds. The key benefits of this regime for fund promoters are that it provides unparalleled flexibility coupled with the certainty of being able to establish the fund at any time, simply by filing the required notice and without the need to obtain JFSC approval.

The key features are as follows.

- No need for JFSC approval and no ongoing regulation, established on a "notification-only" basis.
- Eligible Investors only. This falls under any one of 11 categories, including an investor of USD1 million or more, investors with a net worth of more than USD10 million (excluding their principal place of residence), and those whose ordinary business or professional

activity includes dealing in, managing, underwriting or giving advice on investments.

- A discretionary investment manager may make investments on behalf of investors who do not qualify as Eligible Investors, provided it is satisfied that the investment is suitable for such investors and they are able to bear the economic consequences of the investment.
- No need for Jersey directors or service providers, but a local administrator must be appointed to provide the registered office for any fund company.
- May be listed, provided that the stock exchange allows restrictions on transfers (such that only Eligible Investors may invest).
- There is no audit requirement (unless the fund is a company) and no investment or borrowing restrictions.
- No limitation on the number of investors.

Please refer to **3. Retail Funds** for details of Jersey regulatory classifications which are suitable for retail funds.

Investment Vehicles Which Are Not Funds

An investment vehicle will not be regulated as a fund in Jersey unless it is a scheme or arrangement for the investment of capital:

- which has as its object or one of its objects the collective investment of capital; and
- which operates on the principle of risk spreading, or where units are to be bought back or redeemed continuously or in blocks at short intervals upon the request of the holder and out of the assets of the fund, or where units will be issued continuously or in blocks at short intervals.

Joint ventures, single asset vehicles, single investor vehicles or vehicles which carry on a business (such as property development) also generally fall outside Jersey's funds regulatory regime.

The Application Process

As a first step, personal questionnaires should be submitted to the JFSC in respect of:

- each director of a corporate Regulated Fund or corporate JPF which is not a sub-threshold AIFM; and
- the directors and 10%-plus beneficial owners of any Jersey service provider to a Regulated Fund which is seeking an FSB Licence.

These should be submitted in advance of the fund application, as the JFSC's regulatory checks typically take four to six weeks where the proposed director is not already known to them. The requirement for personal questionnaires does not apply to JPFs unless marketed into the EU/EEA and not sub-threshold. JPFs are subject to a fast-track process whereby the JPF's proposed DSP makes an application via the JFSC's online portal.

In respect of a Regulated Fund, a formal application to the JFSC would follow, enclosing (among other things) the fund's offering document and the relevant JFSC application forms. The cost of the application will vary according to the number of pools of assets (if the fund is an umbrella fund) and the fund's intended Jersey service providers.

Core Documents

The core documents for a Jersey fund are as follows:

- offering document (not required for a JPF or a Notification-Only Fund);

- constitutional documents (eg, memorandum and articles of association/limited partnership agreement/trust instrument);
- subscription documentation for investors and any side letters;
- fund rules, in the case of umbrella funds; and
- material contracts appointing the fund service providers – eg, management agreement, administration agreement, custody agreement and investment management/advisory agreement.

2.1.3 Limited Liability

Jersey's fund structures are designed to limit investor liability to their capital contribution.

For a limited partnership, this is contingent on the limited partners not engaging in the active management of the fund. Jersey's limited partnership law expressly provides for "safe harbours" for a number of specific activities which may otherwise constitute management by a limited partner, including (among other things) the following.

- Consulting with and advising a general partner with respect to the activities of the limited partnership.
- Voting on, or otherwise signifying approval or disapproval of, such matters as:
  - (a) the dissolution and winding-up of the limited partnership;
  - (b) the purchase, sale or other dealing in any asset by or of the limited partnership;
  - (c) the creation or renewal of an obligation by the limited partnership; or
  - (d) a change in the nature of the activities of the limited partnership.

A Jersey company provides investors (as shareholders) with a natural limitation of liability due to the company's distinct legal personality. The circumstances in which the courts may "pierce the corporate veil" and have recourse to shareholders are broadly the same in Jersey as in England: for instance, where a person who is subject to an existing legal obligation deliberately attempts to evade that obligation by interposing a company under their control.

2.1.4 Disclosure Requirements

Jersey Private Funds

A private placement memorandum (PPM) or other offering document is not required for a JPF (although certain AIF Code investor disclosures need to be made, if relevant). However, a PPM may be issued provided that document contains a directors' responsibility statement, together with all of the material information which investors and their professional investors would reasonably require to make an informed judgement about the merits of investing in the fund and the nature and the level of the risks accepted by so investing.

There are also ongoing investor notification requirements if the fund is marketed into the EU under NPPRs. Under the Code of Practice for Alternative Investment Funds and AIF Services Business published by the JFSC (the "AIF Code"), a Jersey alternative investment funds manager (AIFM) which is not sub-threshold is required to periodically disclose matters such as the fund's liquidity arrangements (including special arrangements such as side pockets) as well as risk profile and risk management systems of the fund to investors and the JFSC.

Regulated Funds

A PPM is required to be issued in relation to a Regulated Fund. The PPM will need to contain the content and disclosures set out in:

- the Collective Investment Funds (Certified Funds – Prospectuses) (Jersey) Order 2012 (unless the fund is an Eligible Investor Fund);
- the relevant JFSC Guide; and
- if the fund is an AIF which is not sub-threshold, the AIF Code.

Investors should also be notified of any material changes which may affect their investment. Additional reporting requirements apply in the case of retail funds (please refer to **3.1.4 Disclosure Requirements**).

Finally, the JFSC Guides set out details of matters which need to be notified to the JFSC or which require its prior consent.

Public Companies

A fund which is a public company (of any regulatory classification) must file and send to investors annual audited financial statements, and Regulated Funds must file audited accounts with the JFSC.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Jersey's alternative funds attract a sophisticated investor base, predominantly comprising institutional investors, high net worth individuals and family offices. The island's stable regulatory environment and tax neutrality make it particularly appealing for these discerning investor categories.

2.2.2 Legal Structures Used by Fund Managers

Fund managers and/or investment advisers of alternative investment funds are commonly established in Jersey as companies or limited partnerships, providing them with the flexibility and governance structure conducive to fund management activities.

Where a special purpose Jersey entity needs to be regulated to be appointed as manager or adviser (for example, where acting as AIFM to a JPF which is not sub-threshold or for a Regulated Fund), a simplified licensing regime applies under the JFSC's "managed entity" regime. The key features of this regime are as follows.

- The entity must be administered by a regulated Jersey administrator, which assumes responsibility for ongoing regulatory compliance and often provides one or more directors.
- There is no minimum regulatory capital requirement, but the entity should have such financial resources as are, in the opinion of the directors, sufficient to meet commitments.
- Each director of the entity (and each of its beneficial owners with a 10% or greater interest) is required to submit a personal questionnaire and obtain approval from the JFSC. As international regulatory checks often take three weeks or more to complete for individuals who have not already been approved by the JFSC, these should be completed and submitted as early as possible.
- Registration under the FSJL typically takes two weeks (if, as is usual, personal questionnaires are filed in advance).

2.2.3 Restrictions on Investors

The investor eligibility requirements for each type of fund are summarised below.

JPFs

Each investor in a JPF must be a person who invests at least GBP250,000 (or currency equivalent) or qualifies as a "Professional Investor". A Professional Investor includes:

- a natural or legal person, partnership, trust or other unincorporated association whose

ordinary business or professional activity includes, or it is reasonable to expect that it includes, acquiring, underwriting, managing, holding or disposing of investments, whether as principal or agent, or the giving of advice on investments and their senior employees, directors, partners or expert consultants;
- certain appropriately regulated service providers and their senior employees, directors, partners, expert consultants or shareholders (in each case, as part of remuneration or as an incentive, benefit or reward for acting in such a role);
- a family trust settled by or for the benefit of one or more persons referred to above or their spouses, civil partners or dependants;
- a trustee of an employment benefit or executive incentive arrangement/scheme established for the benefit of one or more persons referred to above or their spouses, civil partners or dependants;
- an individual who has a net worth, or joint net worth with that person's spouse or civil partner, of greater than USD1 million (or currency equivalent) excluding that person's principal place of residence, and any rights under a contract of insurance;
- a body corporate, partnership, trust or other unincorporated association which has assets available for investment of not less than USD1 million (or currency equivalent);
- a carried interest scheme or arrangement established in relation to a JPF;
- a government, local authority, public authority or supranational body in Jersey or elsewhere;
- a "professional client" within the meaning of Annex II to Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments; or
- on application to the JFSC, such other natural or legal persons as the JFSC may deem appropriate on a case-by-case basis.

The JPF regime also expressly recognises that a discretionary investment manager may make investments on behalf of investors who do not qualify as Professional Investors, provided that the manager is satisfied that the investment is suitable for the underlying investors and they are able to bear the economic consequences of the investment.

Expert Fund

An Expert Fund investor must be one of the following:

- an investor making a minimum initial investment or commitment of USD100,000 (or its foreign currency equivalent);
- in the business of acquiring, underwriting, managing, holding or disposing of investments, whether as principal or agent, or giving advice on investments;
- a person with a net worth (or joint net worth with that person's spouse) of more than USD1 million (or its foreign currency equivalent), excluding their principal residence;
- an entity with at least USD1 million (or its foreign currency equivalent) of assets available for investment, connected with the fund or a service provider of the fund (there is a flexible approach for carried interest arrangements); or
- a government, local authority, public authority, or supranational body in Jersey or elsewhere.

Listed Fund

The JFSC Guides do not impose any restrictions on who can invest in a Jersey Listed Fund.

Notification-Only Fund

An Eligible Investor who may invest in a Notification-Only Fund is a person:

- who makes a minimum initial investment or commitment of USD1 million (or its foreign currency equivalent);
- whose ordinary business or professional activity includes dealing in, managing, underwriting or giving advice on investments (or an employee, director, consultant or shareholder of such a person);
- who is an individual with a net worth of over USD10 million or its foreign currency equivalent (calculated alone or jointly with their spouse and excluding their principal place of residence);
- which is a company, limited partnership, trust or other unincorporated association and which either has a market value of USD10 million or equivalent (calculated either alone or together with its associates) or has only Eligible Investors as members, partners or beneficiaries;
- who is, or acts for, a public sector body;
- who is the trustee of a trust which either was established by an Eligible Investor or was established for the benefit of one or more Eligible Investors; or
- who is, or is an associate of, a service provider to the fund (or an employee, director, consultant or shareholder of such a service provider or associate and who acquires the relevant investment by way of remuneration or reward).

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Please refer to **2.1.2 Common Process for Setting Up Investment Funds**: details of the regulatory classification of a Jersey fund will determine which investment limitations or other restrictions (if any) will apply to it.

2.3.2 Requirements for Non-Local Service Providers

Jersey's financial services legislation applies to companies incorporated in Jersey carrying out financial services business anywhere in the world, and to all persons carrying out financial services business in or from within Jersey.

Accordingly, non-Jersey managers or investment managers/advisers of a Jersey fund are not required to become regulated in Jersey under the FSJL, provided that their functions are not carried out in or from within Jersey.

However, the JFSC's prior approval is needed for the appointment of any service providers to a Regulated Fund of any category. An investment manager/adviser of a Regulated Fund is required to provide a confirmation to the JFSC regarding various matters, including that it is:

- regulated in its home jurisdiction (or, otherwise, approved by the JFSC);
- without convictions or disciplinary sanctions;
- solvent; and
- experienced in using similar investment strategies to those adopted by the fund.

Please refer to **2.1.2 Common Process for Setting Up Investment Funds**, regarding the requirement for arranging for a Jersey SPV manager or other service provider to become licensed by the JFSC.

2.3.3 Local Regulatory Requirements for Non-Local Managers

Please refer to **2.3.2 Requirements for Non-Local Service Providers**.

A manager registered in another jurisdiction may, in principle, provide services to a Jersey fund, provided that the requirements of the relevant

JFSC Guide are met (for example, a manager which retains the investment management function must be able to provide the confirmations referred to in **2.1.2 Common Process for Setting Up Investment Funds** if acting for a Regulated Fund).

However, certain fund types must have a Jersey manager or administrator with two appropriately experienced directors, staff and a physical presence in Jersey, unless a derogation from the relevant JFSC Guide is obtained (please see **2.1.2 Common Process for Setting Up Investment Funds** for further information on this point).

2.3.4 Regulatory Approval Process

The regulatory approval process is efficient, with varying timeframes depending on the type of fund. Fast-track authorisation for JPFs can be 48 hours or less, whereas for Regulated Funds it can take several weeks for final JFSC approval if the JFSC raises questions on the fund's application for regulatory approval.

Please refer to **2.1.2 Common Process for Setting Up Investment Funds** for details of the approximate lead time for obtaining regulatory approval for a given category of fund, together with details of which such categories have a fast-track authorisation process.

Retail funds (as referred to in **3. Retail Funds**) are more heavily regulated in Jersey, and this is reflected in the time it typically takes to obtain regulatory approval for such funds.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

There is no Jersey legal definition of "pre-marketing". The EU Pre-Marketing Directive does not apply to Jersey managers marketing funds into the EU under NPPRs; however, individual member states may impose their own pre-marketing requirements.

2.3.6 Rules Concerning Marketing of Alternative Funds

Marketing Jersey Funds to Jersey Investors

There are no marketing restrictions on promoting a Jersey fund to Jersey investors, provided that, where relevant (for example, in relation to an Expert Fund), those persons meet the investor eligibility criteria.

Any marketing of the fund in Jersey should be undertaken by a distributor which holds the relevant registration in Jersey or by the fund itself (if a company). Otherwise, any marketing activities in Jersey should be minimal, such that they fall outside the scope of the FSJL.

Marketing Non-Domiciled Funds to Jersey Investors

Jersey funds are generally used to raise capital from investors internationally. However, many non-domiciled funds are marketed to Jersey investors each year, and each such fund is required to obtain consent from the Jersey Registry in relation to the circulation of its offering documents in Jersey (subject to certain exemptions which are available to funds structured as companies or unit trusts).

The processing time for an application for consent is usually around five working days, and a statutory fee is payable.

However, in the following cases there is an exemption for funds structured as companies or unit trusts.

- Where the fund has no "relevant connection" with Jersey (for example, the management or administration of the fund is not carried on in Jersey).

- Additionally, where the offer is not an offer to the public (it must be made personally to a maximum of 50 persons in Jersey), or the offer is valid in the UK or Guernsey. In summary, this test requires that:
  (a) the offer complies with the Financial Services and Markets Act 2000 in the UK (FSMA) or the fund is authorised under the Protection of Investors (Bailiwick of Guernsey) Law 1987 in Guernsey; and
  (b) the offer is made to a similar type of investor and in a similar manner in Jersey as in the UK or Guernsey (as applicable).

Persons Permitted to Market Non-Domiciled Funds Into Jersey

The considerations set out above in relation to Jersey funds apply.

Regulated, non-Jersey distributors who wish to market certain fund categories to Jersey investors (such as UCITS funds, authorised unit trusts or authorised open-ended investment companies within the meaning of FSMA) are exempt from regulation in Jersey as "overseas distributors". Such marketing must take place on a reverse solicitation basis or by way of advertisements meeting certain content requirements.

2.3.7 Marketing of Alternative Funds

Alternative investment funds in Jersey can be marketed to a wide range of investors, provided they meet the eligibility criteria for the specific fund type being promoted.

Please refer to **2.3.6 Rules Concerning Marketing of Alternative Funds**.

2.3.8 Marketing Authorisation/Notification Process

Please refer to **2.3.6 Rules Concerning Marketing of Alternative Funds**.

2.3.9 Post-Marketing Ongoing Requirements

Please refer to **2.1.4 Disclosure Requirements**.

2.3.10 Investor Protection Rules

Please refer to **2.1.3 Common Process for Setting Up Investment Funds** and **2.2.3 Restrictions on Investors**. Any ownership and other restrictions imposed on funds will depend upon the regulatory classification of the fund, rather than its structure.

The JFSC Certified Fund Code of Practice requires a Regulated Fund to:

- conduct their business with integrity;
- always act in the best interests of unitholders;
- organise and control its affairs effectively for the proper performance of its activities and be able to demonstrate the existence of adequate risk management systems;
- be transparent in its business arrangements with unitholders;
- maintain, and be able to demonstrate the existence of, both adequate financial resources and adequate insurance;
- deal with the JFSC and other authorities in Jersey in an open and co-operative manner;
- not make statements that are misleading, false or deceptive;
- at all times comply and be operated in accordance with any applicable JFSC Guide; and
- comply, where relevant, with the applicable sections of the AIF Code.

The JFSC Guides set out details of matters which need to be notified to the JFSC or which require its prior consent; these include any change of fund service provider and any changes to the fund that are not in accordance with the applicable JFSC Guide. The JFSC Guides relating to funds which target retail investors naturally contain more stringent structural and other restrictions than those aimed at sophisticated or expert investors, for investor protection reasons.

In respect of Regulated Funds, the following must be provided to the JFSC:

- the audited financial statements of the fund; and
- any interim report and accounts of the fund that may be prepared and provided to investors.

In respect of JPFs, the regulated DSP is required to complete and submit a JPF annual compliance return with the JFSC in each relevant year. In addition, the DSP must submit a notice of change or event to the JFSC in the event of any:

- material change in relation to the JPF which would impact on the accuracy of the information provided to the JFSC in the JPF application (including the termination of the JPF (under any circumstances) or any change to the JPF's Jersey service provider(s) other than the DSP (on the basis that there shall be no change in the DSP without the prior approval of an officer of the JFSC));
- non-compliance with the JPF's Jersey AML/CFT obligations;
- material/unresolved complaint(s) made in relation to the JPF; or
- qualified audit of the JPF's annual accounts and financial statements (where the JPF has appointed an auditor).

2.3.11 Approach of the Regulator

The JFSC takes a pragmatic and co-operative approach, and Carey Olsen works closely with the JFSC's Authorisations team to resolve any regulatory questions or issues as and when they arise during a fund application. The JFSC generally publishes guidance whenever it issues a new policy, and tends to be punctual in processing applications, particularly where a degree of commercial urgency is involved.

2.4 Operational Requirements

Any restrictions are mostly contained in the relevant JFSC Guide, although the JFSC's Sound Business Practice Policy also sets out principles regarding the activities that the JFSC considers sensitive from a reputation perspective (which includes, for example, investments in certain goods or services which require payment in advance and pose a risk of fraud, or in weapons, mining or certain crypto-assets).

Please refer to **2.1.2 Common Process for Setting Up Investment Funds** for details of investment restrictions and any specific requirements relating to the custodian.

As mentioned, Jersey service providers to Regulated Funds are required to be licensed under the FSJL, which provides for matters such as insider dealing, market manipulation and the provision of misleading information to persons for the purpose of inducing them to enter into an agreement, the performance of which may constitute financial services business under the FSJL.

2.5 Fund Finance

Access to Fund Finance

There are generally no restrictions in this regard (please refer to **Borrowing Restrictions/Requirements**, regarding borrowings).

Borrowing Restrictions/Requirements

From a regulatory perspective, there are generally no restrictions in the context of non-retail funds. However, the JFSC may undertake additional scrutiny where the permitted borrowing level is high (for example, where an Expert Fund or a Listed Fund is permitted to borrow more than 200% of the fund's NAV).

A full review of the limited partnership agreement (LPA) (or other constitutional documents) of the fund would be required to ensure that there were no restrictions on borrowing or granting security and, in the case of a feeder fund or parallel fund, that there were no restrictions on that fund granting security to secure the borrowings of the main fund.

It is now common for LPAs, and constitutional documents of Jersey funds structured as companies and unit trusts, to contain provisions permitting borrowing (albeit with restrictions in some cases – for example, as to amount or term), the granting of security and the provision of guarantees in respect of borrowings.

Securing Finance

A typical security package would consist of the granting of a security interest over the general partner's right to issue call notices to investors in respect of undrawn capital contributions, and the proceeds of the issuance of such call notices; as well as the bank account(s) into which capital call proceeds are paid.

The security interest agreement would include the granting of a power of attorney from the general partner or manager of the fund so that the secured party could step into the shoes of the general partner to issue capital call notices to investors on an enforcement of the security, in the event that the general partner or manager failed to do so.

A financing statement in respect of the security would usually be registered on the Jersey Security Interests Register.

Common Issues in Relation to Fund Finance

Lenders will usually require a review of any side letters entered into with investors to ensure there are no provisions that may cut across any security which may be granted or which could affect the general partner's rights to make capital calls from investors.

In order to perfect any capital call security, it is not necessary that notice of such security be provided to investors. However, there remain advantages to electing to give notice to investors.

Any other relevant regulatory issues should be considered; for example, where a fund is an AIF, the AIFMD analysis may require that the fund is unleveraged or that leverage is kept to below a certain level.

2.6 Tax Regime

Tax Framework

Jersey funds (regardless of their structure) are not generally subject to any Jersey tax. No capital gains, capital transfer, wealth or inheritance taxes are payable in relation to the issuance or realisation of investments in a Jersey fund (assuming that the fund does not invest in Jersey property or buildings). Additionally, no corporation tax, profits tax or stamp duty is payable, and distributions may be made without withholding or deduction for payment of Jersey income tax.

There is no distinction between the types of investor for tax purposes. If distributions are of an income nature, investors who are Jersey-resident individuals will need to declare and pay Jersey income tax in the usual manner (this is the case regardless of whether the fund is domiciled in Jersey or elsewhere), but there is no capital gains tax in Jersey. Non-Jersey investors should seek taxation advice in their own countries of residence to ensure that an investment is suitable for them.

Tax Treaty Network

Please refer to **FATCA and CRS Regimes**, for details of the information exchange arrangements relating to FATCA and the CRS. The main impacts of those arrangements are that certain information regarding funds' investors is required to be collected and reported by Jersey funds, and that information may, in turn, be shared between the Jersey and other countries' taxation authorities.

Jersey also has information exchange and/or double taxation agreements with a number of countries, and is able to comply with all required international reporting and transparency requirements.

FATCA and CRS Regimes

Jersey has concluded an intergovernmental agreement (IGA) with the USA to implement FATCA. Jersey funds are generally foreign (non-US) financial institutions for these purposes, and will need to provide information about the identity of limited partners who are US persons or limited partners with beneficial owners who are US persons to the Comptroller of Taxes in Jersey, who will then forward that information to the competent authority in the USA. Provided that a fund complies with its obligations, it should not incur any FATCA withholding taxes.

In addition to the IGA entered into with the USA, the States of Jersey and the UK government have entered into an inter-governmental agreement (UK IGA, and together with the US IGA, the "IGAs") for the implementation of information-exchange arrangements, based on FATCA, whereby relevant information reported to the Jersey authorities in respect of a person or entity who is resident in the UK for tax purposes is shared with the UK's HMRC. Under the UK IGA, Jersey funds may be required to provide information to the Jersey authorities about their investors and such person's beneficial owners and interests in the fund in order to fully discharge their reporting obligations; in the event of any failure or inability to comply with the proposed arrangements, they may suffer a financial penalty or other sanction under Jersey law.

The OECD has since released the Standard for Automatic Exchange of Financial Account Information in Tax Matters (CRS), following approval by the OECD Council. This includes a model regime to serve as the common standard on reporting and due diligence for financial account information. Like FATCA and the IGAs, the CRS requires financial institutions in participating jurisdictions to follow common due diligence procedures and to report specified financial information to their tax authorities, which is then automatically exchanged with other participating jurisdictions. Jersey is committed to domestic implementation of the CRS, and Jersey funds are usually expected to be financial institutions for CRS purposes.

Economic Substance Regime

Jersey has implemented economic substance legislation, whereby any company which is resident in Jersey for tax purposes, and which receives income from activities such as fund management in Jersey, is required to meet an economic substance test. The test therefore applies to Jersey fund managers (and general partners if the fund has not appointed a separate manager). Self-managed funds (ie, those which have not appointed a separate manager) have subsequently been brought within this scope.

The legislation came into effect in response to the EU Code of Conduct Group's assessment of Jersey's tax policy framework, aimed at ensuring the island adheres to the principles of fair taxation and aligns with the EU's and OECD's standards to prevent base erosion and profit shifting (BEPS). Although Jersey received the highest possible rating in all ten assessed areas and was confirmed as a co-operative tax jurisdiction, the Code of Conduct Group expressed concern that the absence of a statutory substance requirement increased the risk of profits being registered in Jersey which do not reflect real economic activity in the jurisdiction. While these changes present new compliance considerations, they are in line with Jersey's commitment to uphold international tax co-operation and maintain its status as a co-operative jurisdiction. The adjustments reinforce the island's reputation as a transparent and well-regulated financial centre.

The economic substance test is met if:

- the company is directed and managed in Jersey (for example, if most board meetings are held in Jersey and the quorum is met by those physically present at the meeting);
- core-income generating activity (for example, taking decisions on the holding and selling of investments, calculating risks and reserves and/or preparing reports and returns to investors and the JFSC) in relation to the fund management is principally carried out in Jersey; and
- there are adequate employees and physical assets, and an adequate level of expenditure is incurred, in Jersey.

As most fund managers in Jersey already meet the above requirements, the economic substance law has not had a substantial impact on the funds industry in Jersey.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Please refer to **2.1.1 Fund Structures**. The same types of legal vehicles are available to retail funds, and in the authors' experience, OCIFs are typically established as unit trusts or companies.

3.1.2 Common Process for Setting Up Investment Funds

Retail Funds

Retail funds in Jersey encompass open-ended funds which are to be offered to retail investors and which do not qualify as an Expert Fund, Listed Fund or Eligible Investor Fund. The first stage of the approval process is the approval of the promoter. This approval can be sought simultaneously with the submission of documents for review by the JFSC. Once such approval has been obtained, any JFSC comments on the documents have been resolved and the JFSC has approved the identity of the fund's service providers, the JFSC will issue the necessary consents. The extent of the JFSC's review and of the regulatory requirements it imposes will depend on the nature of the fund and, in particular, on any minimum level of investment or other restrictions on who can invest, as well as on whether the fund is open or closed-ended.

Under the JFSC's Guide for Open-Ended Collective Investment Funds (the "OCIF Guide"), in assessing a proposed promoter or promoting group, the JFSC will have regard to its:

- track record and relevant experience;
- reputation;
- financial resources; and
- spread of ultimate ownership.

Their assessment will depend on the type of investor to which the proposed fund is targeted: the higher the minimum investment and/ or the more that the fund is targeted towards professional or institutional investors who have knowledge of the industry and have the experience and resources to look after themselves, the more the JFSC is inclined to relax its requirements.

OCIFs

Funds which do not fall into any of the regulatory classifications referred to in **2.1.2 Common Process for Setting Up Investment Funds** and which may be offered to retail investors (OCIFs) can be established under the OCIF Guide.

This is a more heavily regulated category of fund, which contains additional investor protections, such as:

- criteria applicable to the promoter;
- investment restrictions (which vary according to the fund type – for example, special rules apply to feeder funds and funds of funds); and
- a requirement for the JFSC to approve all the material fund documentation.

Derogations may be sought from the OCIF Guide, but the JFSC will have regard to matters such as minimum investment when deciding whether to grant these.

Recognised Funds

Recognised Funds are rarely established in Jersey, and a number of prescriptive rules apply to them. This category of fund is intended to be freely marketable to retail investors in the UK and elsewhere.

Given the rarity of Recognised Funds in Jersey, this regulatory category is not considered further in this section, which focuses on OCIFs.

3.1.3 Limited Liability

Please refer to **2.1.3 Limited Liability**.

3.1.4 Disclosure Requirements

Please refer to **2.1.4 Disclosure Requirements**. The fund documents should be carefully checked against the OCIF Guide to ensure compliance with the various requirements set out therein (which cover, among other things, the matters referred to in **3.4 Operational Requirements**).

Various investor reporting requirements are also contained in the OCIF Guide, including that at least two reports must be published and sent to investors each year. Investors must be notified of all changes to the fund's constitutive documents, unless the trustee or custodian certifies that in its opinion the changes will not prejudice investors' interests and files that certification with the JFSC.

The latest available selling and redemption prices or net asset value must be available to all investors.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

The market in Jersey generally targets sophisticated investors who fall into the institutional or high net worth categories (in the authors' experience, there is currently less investor appetite for Jersey retail funds than for non-retail options).

3.2.2 Legal Structures Used by Fund Managers

Please refer to **2.1.1 Fund Structures**.

3.2.3 Restrictions on Investors

OCIFs are available to a broad range of potential investors, subject to any eligibility requirements provided for in the constitutive documents of the OCIF.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

The OCIF Guide contains a number of investment and borrowing restrictions which vary according to the type of fund – for example, whether it is a general securities fund, a fund of funds or a feeder fund. However, this firm has successfully obtained derogations from certain investment restrictions set out in the OCIF Guide (noting that such derogations must be applied for on a case-by-case basis and are not available in every instance).

Where the OCIF is an umbrella fund, each of its sub-funds will be treated separately for the purposes of determining which restrictions will apply to that sub-fund.

3.3.2 Requirements for Non-Local Service Providers

Please refer to **2.3.2 Local Regulatory Requirements for Non-Local Service Providers**.

The OCIF Guide sets out specific requirements regarding service providers, such as the manager (see **3.3.3 Local Regulatory Requirements for Non-Local Managers**) and the trustee/custodian, which must be a company that is a member of a major banking or insurance group of companies or, otherwise, an institution that is acceptable to the JFSC.

The OCIF Guide also contains the requirement that certain service providers, including the manager/administrator and trustee or custodian, must be an appropriately licensed Jersey company with staff and premises in Jersey. Again, it is possible to seek a derogation from such requirements.

3.3.3 Local Regulatory Requirements for Non-Local Managers

Please refer to **2.3.3 Local Regulatory Requirements for Non-Local Managers**.

A manager of an OCIF is required to be engaged primarily in the business of fund management, and to have sufficient financial resources at its disposal to enable it to conduct its business effectively and meet its liabilities; in particular, it must be in compliance with the financial resource requirements of the relevant JFSC Code of Practice.

As mentioned previously, the manager is required to be a company incorporated and resident in Jersey. It is not, however, essential for the manager to have staff and premises on the island if a Jersey incorporated company which does have staff and premises on the island is appointed as administrator.

3.3.4 Regulatory Approval Process

Retail funds are more heavily regulated in Jersey, and this is reflected in the time it typically takes to obtain regulatory approval in relation to them.

There is a two-stage JFSC review process, and an application generally takes a matter of weeks to process.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Please refer to **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**.

3.3.6 Rules Concerning Marketing of Retail Funds

There are no specific restrictions. The OCIF Guide seeks to contain the criteria that the JFSC expects to be met in relation to an OCIF which is to be marketed to members of the general public, and who might be regarded as inexperienced in matters of investment and least able to bear the consequences of any loss of their investments.

3.3.7 Marketing of Retail Funds

Please refer to **2.3.5 Rules Concerning Marketing of Retail Funds**.

3.3.8 Marketing Authorisation/Notification Process

Please refer to **2.3.6 Rules Concerning Marketing of Alternative Funds**.

3.3.9 Post-Marketing Ongoing Requirements

Please refer to **2.1.4 Disclosure Requirements**.

3.3.10 Investor Protection Rules

Please refer to **2.3.10 Investor Protection Rules** and **3.4 Operational Requirements**. Given the nature of an OCIF's potential investors, the OCIF Guide is more prescriptive in terms of structural and investment restrictions than is the case for non-retail funds (for example, an OCIF may not lend, guarantee or otherwise become liable for any obligations or indebtedness of any person without the prior, written consent of its trustee or custodian).

The JFSC's prior consent is typically required for any material changes to the fund documents.

3.3.11 Approach of the Regulator

Please refer to **2.3.11 Approach of the Regulator**. The JFSC typically takes a more stringent approach when considering issues which arise or material changes in the context of an OCIF.

3.4 Operational Requirements

Please refer to **2.4 Operational Requirements** and **3.3.2 Requirements for Non-Local Service Providers**.

The OCIF Guide contains specific requirements in relation to the valuation and pricing of an OCIF's assets and matters such as meetings, charges and fees, investment limits, borrowing powers, the frequency of dealing and redemptions. Additionally, the OCIF Guide applies safeguards in certain cases – for example, where an OCIF permits the issuance of units to investors for assets other than cash.

3.5 Fund Finance

Please refer to **2.5 Fund Finance**. In the case of an OCIF, there are certain additional restrictions (for example, a feeder fund or a fund of funds may only borrow up to 10% of its NAV on a temporary basis for the purposes of meeting redemption requests or defraying operating expenses).

3.6 Tax Regime

Please refer to **2.6 Tax Regime**.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

In light of the UK's departure from the EU, Jersey's regulatory framework continues to provide stability and a degree of certainty for investment funds. The island's authorities remain engaged in dialogue with industry stakeholders to ensure that Jersey's regulatory environment stays conducive to investment and aligned with international standards. Looking ahead, there are ongoing discussions about refining the regulatory framework governing investment funds. The aim is to streamline processes, where feasible, to encourage efficiency and accessibility without compromising the robust oversight integral to investor protection.

Jersey's ability to adapt its legislative and regulatory structures is indicative of the island's forward-thinking approach. This agility ensures that Jersey remains a competitive jurisdiction for fund establishment and management. The focus remains on ensuring that regulatory changes protect investors and the integrity of the market, while also facilitating business growth and innovation within the funds sector.

The JFSC continues to provide clear guidance on these changes, assisting entities in understanding and implementing the necessary measures to comply with the economic substance requirements. The JFSC's approach is to work in collaboration with industry professionals to ensure that any reforms are pragmatic and reflective of the needs of the industry, while meeting international regulatory standards.

As a legal firm deeply engaged in the funds industry, Carey Olsen remains prepared to assist clients in interpreting these reforms and understanding their implications. It is expected that the firm will continue to play an active role in providing feedback on proposed legislative changes, ensuring that the views and concerns of industry participants are considered.

In summary, the recent and proposed changes to Jersey's legal, regulatory and tax framework are designed to ensure that the jurisdiction remains compliant with international standards, fostering a secure and attractive environment for investment funds.

LUXEMBOURG

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Luxembourg City
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Law and Practice

Contributed by:
Evelyn Maher, Gaston Aguirre Draghi and Djelloul Mansour
BSP

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BSP is an independent full-service law firm based in Luxembourg that is committed to providing the best possible legal services to its domestic and international clients in relation to all aspects of Luxembourg business law. The firm's lawyers have developed particular expertise in banking and finance, capital markets, corporate law, dispute resolution, employment law, investment funds, intellectual property, private wealth, real estate and tax. In these practice areas, as in others, the firm's know-how, and its ability to work in cross-practice teams and to swiftly adapt to new laws and regulations, allows it to provide clients with timely and integrated legal assistance vital to the success of their business. Building on the synergy of its different professional experiences and the richness of its diverse cultural background, BSP stands ready to meet its clients' legal needs, no matter how challenging they are.

Authors

Evelyn Maher is head of BSP's investment management department. She has been active in the Luxembourg investment funds market since 2001, assisting fund promoters and asset managers in relation to the structuring and establishment of funds including private equity, venture capital, loan origination, loan participation and real estate. She provides advice on compliance with the investment funds regulatory regime, particularly the Alternative Investment Fund Managers Directive (AIFMD). Evelyn also offers ongoing assistance with closings, investments, divestments, liquidation and general issues arising throughout the life of a fund. She has also assisted in relation to the listing of securities on both the regulated and Euro MTF markets operated by the Luxembourg Stock Exchange.

Gaston Aguirre Draghi is an associate in BSP's investment management practice. He advises clients on the structuring, establishment and marketing of Luxembourg alternative investment funds and UCITS funds. Prior to joining BSP, Gaston gained valuable experience working in international law firms in Argentina and Luxembourg. He graduated in law from the University of Buenos Aires in Argentina and revalidated his law degree in Spain at the University of La Rioja. He holds an LLM in International Business Law from IE University and a Master's in Spanish Business Law from the Higher Institute of Law and Economics (ISDE) in Spain.

Djelloul Mansour is an associate in BSP's investment management practice. He advises clients on the structuring, establishment and marketing of Luxembourg alternative investment funds. Djelloul holds a Master II in European and International Tax Law and a Master I in Tax Law, both from Aix-Marseille University. He joined BSP in 2022.

BSP

11 rue du Château d'Eau
L-3364 Leudelange
Luxembourg

Tel: +352 260 251
Fax: +352 260 259 99
Email: marketing@bsp.lu
Web: www.bsp.lu

Right by you in Luxembourg

1. Market Overview

1.1 State of the Market

As the second-largest fund market in the world after the USA, Luxembourg has earned itself a reputation for stability, a business-friendly environment and excellence in the provision of services to the investment management industry. The world's leading asset managers have chosen Luxembourg as a centre for their international fund ranges, and Luxembourg regulated funds are now distributed in more than 80 countries throughout the world. Luxembourg had approximately EUR5.5 trillion in assets under management (AUM) in regulated funds as of 31 May 2024.

Since the first Undertakings for Collective Investment in Transferable Securities (UCITS) Directive in 1985, Luxembourg has been at the forefront of the implementation of European financial legislation, showing an ability to evolve and adapt quickly to changing requirements. There now exists a wide choice of vehicles, allowing managers to structure a fund (both alternative investment funds (AIFs) and retail funds) in Luxembourg that best suits their own needs as well as the needs of their investors.

The success of Luxembourg as a financial centre is testament to the strong regulatory and operational environment that Luxembourg has created. Its willingness to adapt to change will ensure that, over the coming years, the industry will continue to thrive.

In addition, to illustrate some recent trends, and given Luxembourg's status as a leading private markets hub, it is well positioned for 2025 to capitalise on the new European long-term investment fund (ELTIF) 2.0 structure, regulated per ELTIF regulatory technical standards (RTS) as referenced in **4. Legal, Regulatory or Tax Changes**, and the burgeoning worldwide trends of retailisation in private markets. Out of 132 ELTIFs as of September 2024, 84 are domiciled in Luxembourg, holding EUR7.7 billion in AUM (as of the end of 2023). Finally, the trend of more sustainable funds in Europe that are domiciled in Luxembourg keeps evolving. This trend towards more sustainable investing is expected to continue during 2025, as the AUM of asset managers with sustainable funds domiciled in Luxembourg jumped 12.3% from 2022 to the end of June 2024.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

The principal legal vehicles used to set up alternative funds in Luxembourg are the following.

- Undertakings for collective investment (Part II UCI), governed by Part II of the Law of 17 December 2010 (the "UCI Law"), which may be constituted in the form of a common fund (*fonds commun de placement*) (FCP), an investment company with variable capital (*société d'investissement à capital variable* (SICAV)) or an investment company with fixed capital (*société d'investissement à capital fixe* (SICAF)). An amendment to the UCI Law in 2023 has broadened the corporate forms available for a Part II UCI. They may now be established as SICAVs in the form of a partnership limited by shares (*société en commandite par action* (SCA)), a common limited partnership (*société en commandite simple* (SCS)), a special limited partnership (SLP; *société en commandite spéciale* (SCSp)) or a co-operative society (*société coopérative*) organised as a public limited liability company (*société anonyme* (SA)) or a private limited liability company (*société à responsabilité limitée* (Sàrl)), as opposed to just an SA. Part II UCIs are supervised by the *Commission de Surveillance du Secteur Financier* (CSSF) which is the supervisory authority in Luxembourg. The main advantage of these funds is that they are open to all types of investors, including retail investors.
- Specialised investment funds (SIFs; *fonds d'investissement spécialisé*), governed by the Law of 13 February 2007 (the "SIF Law"), which may be constituted as an FCP, SICAV or SICAF. While SIFs have the advantage of having almost no restrictions in terms of what they can invest in, they are only open to well-informed investors. As with Part II UCIs, they are supervised by the CSSF.
- Investment companies in risk capital (*sociétés d'investissement en capital à risque*) (SICARs), governed by the Law of 15 June 2004 (the "SICAR Law"), which may only be constituted as a corporate or partnership entity (ie, they cannot be FCPs). SICARs have the advantage of having no investment diversification rules, but they must invest in risk capital. As such, this vehicle is generally used for investments in venture capital and private equity. SICARs are supervised by the CSSF and are only open to well-informed investors.
- Reserved alternative investment funds (*fonds d'investissement alternatif réservé*) (RAIFs), governed by the Law of 23 July 2016 (the "RAIF Law"), which may be constituted as an FCP, SICAV or SICAF (in the case of a SICAV or SICAF, any of the available corporate or partnership forms can be chosen). RAIFs can choose to follow the SIF or SICAR regime in terms of the type of assets invested in. The particular advantage of this vehicle is that it is not subject to the supervision of the CSSF and, as such, a RAIF can potentially be brought to the market more quickly than supervised entities. Unlike Part II UCIs, SIFs and SICARs, a RAIF is always obliged to appoint an authorised external alternative investment fund manager (AIFM).
- The Luxembourg SLP, which is an unregulated and unsupervised entity. The SLP is characterised by its contractual freedom and is not subject to any investment or diversification constraints.

RAIFs, Part II UCIs, SIFs, SICARs and SLPs that have designated an AIFM established in the European Economic Area (EEA) can market their shares, units or limited partnership interests to professional investors throughout the EEA, pursuant to the specific notification procedure provided for by the Alternative Investment Fund Managers Directive (AIFMD).

Each Part II UCI, SIF, SICAR and RAIF may be established as an umbrella fund, allowing the creation of multiple compartments. This option is not available to the unregulated SLP.

Any such vehicle set up in the form of an FCP issues units. Those in corporate form issue shares, and those in the form of partnerships issue limited partnership interests.

2.1.2 Common Process for Setting Up Investment Funds

The Part II UCI, the SIF and the SICAR are subject to authorisation by the CSSF prior to establishment. An application file must be submitted to the CSSF consisting of at least the following documents (there are certain ancillary documents, and the CSSF may always request further information):

- an offering document;
- a constitutive document;
- agreements with key service providers including the depositary, the AIFM, any delegated portfolio manager and the central administration agent;
- information on the directors or managers, who must be of sufficiently good repute and be sufficiently experienced;
- a packaged retail and insurance-based investment products key information document (PRIIPs KID) if retail investors are targeted; and
- application forms.

The RAIF is not subject to approval by the CSSF, but the following documents will still be required:

- an offering document;
- a constitutive document; and
- agreements with key service providers including the depositary, the AIFM, any delegated portfolio manager and the central administration agent.

The SLP is frequently structured as an unregulated AIF, which is not authorised and not regulated by the CSSF. There is no requirement to have an offering document, though one is frequently prepared for marketing reasons. The limited partnership agreement is the key document for an SLP. Given that there is no approval process at the CSSF, the set-up time is shorter for the RAIF and the SLP.

However, for all vehicles, time for due diligence performed by the service providers as well as time to complete bank account opening processes needs to be factored into the establishment process.

The largest set-up costs are generally legal costs, though service providers also sometimes charge a set-up or onboarding fee. In addition, there are fees payable to the CSSF for regulated funds. For a Part II UCI, SIF and SICAR, the CSSF charges an examination fee and an annual fee for its supervisory activity. The fee amount differs depending on whether the fund is a standalone or an umbrella fund, and on whether it is self-managed or not. For example, the examination fee for a standalone Part II UCI, SIF or SICAR is EUR4,650, whereas for an umbrella fund it is EUR9,250.

2.1.3 Limited Liability

The liability of an investor is generally limited to its commitment or subscription to the fund. In the case of an AIF in the form of an SCA, SCSP or SCS, there will always be an unlimited partner, which is generally an entity controlled by the fund initiators and usually referred to as the general partner. The general partner has unlimited and joint and several liability for all the obligations of the fund.

2.1.4 Disclosure Requirements

For a Part II UCI, SIF, RAIF or SICAR, a prospectus or offering document and an audited annual report must be made available to investors. A PRIIPs KID must also be made available if the fund is to be marketed to retail investors. The Part II UCI must also prepare a semi-annual report.

For an SLP, there are no specific disclosure requirements unless it has appointed a fully authorised AIFM, in which case it is obliged to also prepare audited annual accounts.

Pursuant to the AIFMD, certain disclosures must be made to investors in the offering documents of those funds managed by an AIFM.

In addition, regulated vehicles (SIF, SICAR and Part II UCI) are subject to periodic reporting to the CSSF for statistical and oversight purposes.

Finally, any AIFs managed by an AIFM will be indirectly subject to the Annex IV reporting requirements, with reports to be submitted to the CSSF pursuant to the AIFMD.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

There has been an increased demand for access to AIFs in recent years. Investors are seeking more diversification than that offered by retail funds. Well-informed and institutional investors represent the majority of the investors in AIFs in Luxembourg, though there has been a trend towards retailisation of AIFs.

2.2.2 Legal Structures Used by Fund Managers

The legal structure used by alternative fund managers in Luxembourg will depend on the type and location of the investors, as well as the nature of the investment. SIFs, SICARs and RAIFs are intended for well-informed investors, and Part II UCIs are often used if there is an intention to target retail investors.

Increasingly, unregulated RAIFs or SLPs (managed by an authorised AIFM) are used as they offer more certainty in terms of time to market.

2.2.3 Restrictions on Investors

SIFs, SICARs and RAIFs are restricted to investment by well-informed investors. The Part II UCI can be marketed to both professional and retail investors in Luxembourg. There are no restrictions under Luxembourg law on who the limited partnership interests of an SLP can be sold to. However, for marketing in other jurisdictions, the AIFMD marketing passport will only allow marketing of the interests in an SLP to professional investors.

Pursuant to the Law of 12 July 2013 on AIF managers (the "AIFM Law"), authorised AIFMs established in Luxembourg, in another EEA member state or in a third country are authorised to market AIFs they manage to retail investors in Luxembourg, provided certain conditions are met, as follows.

- The AIFs must be subject in their home state to permanent supervision in order to ensure the protection of investors.
- The AIFs must be subject in their home state to regulation providing investors with guarantees of protection at least equivalent to those provided by Luxembourg laws governing AIFs authorised to be marketed to retail investors

in Luxembourg. The home state supervision must also be equivalent to that provided in Luxembourg.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

The regulatory regime applicable to an AIF differs depending on the type of fund. All AIFs are indirectly subject to the provisions of the AIFM Law. The extent to which the AIFM Law is applicable depends on whether they are managed by a fully authorised AIFM or a registered AIFM.

The Part II UCI is subject to investment restrictions and risk diversification rules arising from the Law of 17 December 2010 on undertakings for collective investment (the “UCI Law”) and various implementing CSSF circulars. For example, generally, a Part II UCI cannot:

- invest more than 10% of its assets in securities that are not listed on a stock exchange and are not traded on another regulated market that operates regularly and is recognised and open to the public;
- acquire more than 10% of the same type of securities issued by the same issuing body; or
- invest more than 20% of its net assets in securities issued by the same issuing body.

These general investment restrictions do not apply to Part II UCIs that are fund-of-fund structures if the investment funds in which the Part II UCI shall invest are open-ended and themselves subject to similar general investment restrictions. In addition, these general investment restrictions do not apply to Part II UCIs that are mainly investing in either venture capital or real estate or are pursuing alternative investment strategies.

Part II UCIs may in principle borrow the equivalent of up to 25% of their net assets without restriction as to the intended use thereof.

Part II UCIs that are mainly investing in real estate may borrow the equivalent of up to an average of 50% of the valuation of all their properties.

Borrowings of Part II UCIs that are mainly pursuing alternative investment strategies (hedge funds) may be up to 400%.

For SIFs, there are no asset restrictions, but the SIF may not invest more than 30% of its assets or commitments in securities of the same type issued by the same issuer.

A RAIF that has chosen the SIF regime is subject to similar rules.

A SICAR is obliged to invest its funds in assets representing risk capital but is not subject to any diversification rules. A RAIF that has chosen the SICAR regime is subject to the same rules.

In general, an SLP is not subject to any investment restrictions or risk diversification rules.

AIFs may choose one of the EU labels, such as European venture capital fund (EUVECA), European social entrepreneurship fund (EUSEF) or ELTIF, in which case they will also be governed by the rules applicable to those regimes.

2.3.2 Requirements for Non-Local Service Providers

Luxembourg AIFs may be managed by an AIFM based in a member state of the EEA. If an AIFM established in another member state intends to market units or shares of an EEA AIF that it manages to professional investors in Luxembourg, the competent authorities of the home member state of the AIFM must transmit the notification file to the CSSF.

For RAIFs, SIFs, SICARs and Part II UCIs, the respective depositary must either have its registered office in Luxembourg or have a branch there if its registered office is in another EU member state. The central administration of these entities must be located in the Grand Duchy of Luxembourg.

CSSF Circular 22/811 clarified that foreign investment fund managers with the appropriate licence may act as administrator for non-regulated funds in Luxembourg (eg, SLPs).

2.3.3 Local Regulatory Requirements for Non-Local Managers

Part II UCIs, SIFs or RAIFs established in the form of an FCP must appoint a Luxembourg AIFM.

AIFs in corporate or partnership form can appoint an AIFM established anywhere in the EEA.

To manage a Luxembourg fund, such AIFMs must provide a notification to their home supervisory authority, who will transmit it to the CSSF.

The portfolio management of Luxembourg AIFs can be delegated to managers situated in third countries, provided that in the case of regulated funds such delegation is subject to the prior approval of the CSSF.

AIFMs that intend to delegate to third parties the task of carrying out functions on their behalf must notify the supervisory authorities of their home member state before the delegation arrangements become effective.

2.3.4 Regulatory Approval Process

The approval process usually takes between three to six months and is dependent on several factors. These include:

- the completeness of the initial application;
- the speed with which the CSSF's queries are answered;
- whether it is a first-time fund; and
- the nature of the investment policy.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

Pursuant to the AIFM Law, an AIFM established in another member state that is pre-marketing, or intending to pre-market, an AIF to professional investors in Luxembourg must notify the supervisory authority of its home country (the CSSF in the case of Luxembourg AIFMs), including:

- specifying in which countries and during which periods the pre-marketing is taking or has taken place; and
- providing a brief description of the pre-marketing, including information on the investment strategies presented and, where relevant, a list of the AIF(s) and compartments of AIF(s) that are or were subject to pre-marketing.

Information presented to potential professional investors in the context of pre-marketing cannot:

- be sufficient to allow investors to commit to acquiring units or shares of a particular AIF;
- amount to subscription forms or similar documents, whether in draft or final form; or
- amount to constitutional documents, a prospectus or offering documents of a not-yet-established AIF in final form.

The AIFM must ensure that professional investors do not acquire units or shares in an AIF through pre-marketing, and that investors contacted as part of pre-marketing may only acquire units or shares in that AIF after the formal marketing notification.

Any subscription by professional investors, within 18 months of the AIFM having begun pre-marketing, to units or shares of an AIF referred to in the information provided in the context of pre-marketing, or of an AIF established as a result of the pre-marketing, shall be considered to be the result of marketing and shall be subject to the applicable notification procedures (see **2.3.8 Marketing Authorisation/Notification Process**).

2.3.6 Rules Concerning Marketing of Alternative Funds

AIFMs marketing AIFs in Luxembourg must comply with the provisions of the AIFMD. Where another firm is marketing in Luxembourg, it could be considered to be carrying out an activity of the financial sector and should thus be licensed or otherwise authorised to do so pursuant to the Law of 5 April 1993 on the financial sector. Firms from other EU member states with the appropriate licence pursuant to the Markets in Financial Instruments Directive (MiFID) would be authorised to carry out distribution activities in Luxembourg.

All marketing communications will need to comply with the requirements of Article 4 of Regulation 2019/1156 on facilitating cross-border distribution of collective investment undertakings. CSSF Circular 22/795 stipulates that Luxembourg AIFMs must provide the CSSF with information regarding marketing communications, and the CSSF will conduct testing to verify their compliance with the applicable requirements under Article 4.

2.3.7 Marketing of Alternative Funds

SIFs, SICARs and RAIFs are reserved for and can only be marketed to well-informed investors in Luxembourg. Well-informed investors are institutional investors, professional investors or any other investors who meet the following conditions:

- they have confirmed in writing that they adhere to the status of well-informed investor; and
- they invest a minimum of EUR100,000, or have been the subject of an assessment made by an entity such as a bank, management company or AIFM certifying their expertise, experience and knowledge in adequately apprising an investment in a fund.

Part II UCIs can be marketed to any type of investors (both retail and well-informed investors).

In addition to the foregoing restrictions, EEA AIFs managed by an authorised AIFM can be marketed to professional investors in Luxembourg pursuant to Article 32 of the AIFMD.

As previously discussed, in certain circumstances authorised AIFMs may market non-Luxembourg AIFs to retail investors in Luxembourg.

EuVECAs and EUSEFs, governed by Regulation (EU) No 345/2013 and Regulation (EU) No 346/2013, respectively, can be marketed to professional investors and other investors, provided that each investor (noting that such funds could take one of the available forms of fund in Luxembourg like SICAR or SIF):

- commits to investing a minimum of EUR100,000; and

- states in writing that they are aware of the risks associated with the envisaged investment.

ELTIFs, which are AIFs that could take the form of one of the available funds in Luxembourg, are, depending on the rules that they comply with, potentially available to be marketed to both retail and professional investors upon notification in accordance with Article 32 of the AIFMD.

2.3.8 Marketing Authorisation/Notification Process

An AIFM wishing to market to professional investors in Luxembourg must submit a notification to the competent authorities of its home member state (the CSSF for Luxembourg AIFMs) in respect of each EEA AIF that it intends to market. This does not apply to Luxembourg AIFMs marketing Luxembourg regulated funds. The notification must comprise certain information, including:

- a notification letter, with a programme of operations identifying the AIFs the AIFM intends to market and information on where the AIFs are established;
- the AIF rules or instruments of incorporation;
- identification of the depositary of the AIF;
- an indication of the member state in which it intends to market the units or shares of the AIF to professional investors; and
- information about arrangements made for the marketing of AIFs and, where relevant, information on the arrangements established to prevent units or shares of the AIF from being marketed to retail investors, including in the case where the AIFM relies on activities of independent entities to provide investment services in respect of the AIF.

The competent authorities of the home member state of the AIFM should, no later than 20 working days after the date of receipt, transmit the complete notification file to the CSSF. From the date of notification of such transmission, marketing can begin.

Those AIFMs wishing to market non-Luxembourg AIFs to retail investors must follow the detailed rules laid down in CSSF Regulation 15-03 on the marketing of foreign AIFs to retail investors in Luxembourg. Prior to marketing its units or shares to retail investors in Luxembourg, any foreign AIF must have obtained an authorisation for such marketing by the CSSF.

2.3.9 Post-Marketing Ongoing Requirements

Material Changes

In the event of a material change in the information contained in its original marketing notification file, an AIFM must provide written notice of this change to its home state competent authority (the CSSF in the case of Luxembourg AIFMs), by resubmitting a marked-up version of the original notification file indicating the proposed changes.

All material changes planned by the AIFM must be notified to the CSSF at least one month before implementing the change, or immediately after an unplanned change has occurred.

De-Notification

An AIFM may de-notify arrangements made for marketing as regards units of shares of some or all of its AIFs in Luxembourg, if the following conditions are met:

- other than in respect of closed-ended funds and ELTIFs, a blanket offer is made to repurchase or redeem, free of any charges or

deductions, all such units or shares held by Luxembourg investors;
- the intention to terminate arrangements made for marketing such units or shares is made public by means of a publicly available medium; and
- any contractual arrangements with financial intermediaries or delegates are modified or terminated, with effect from the date of de-notification, in order to prevent any new or further direct or indirect offering or placement of such units or shares.

The de-notification procedure is carried out through the home supervisory authority of the AIFM, which then informs the CSSF.

However, if an AIFM intends to cease the marketing of its non-Luxembourg AIF to retail investors in Luxembourg, it must inform the CSSF about whether Luxembourg investors are still invested in the AIF.

2.3.10 Investor Protection Rules

SIFs, SICARs and RAIFs are intended for well-informed investors that are able to adequately assess the risks associated with an investment in such vehicles.

Part II UCIs can be marketed to retail investors, but the applicable investment restrictions, in addition to the fact that they are supervised by the CSSF, adds to investor protection.

The fact that all AIFs bar the unregulated SLP must appoint a depositary and an auditor provides additional protection for investors.

Any AIF managed by an authorised AIFM needs to provide audited annual accounts that, in the case of regulated AIFs, need to be provided to the CSSF. The CSSF is also made aware of the content of the management letters.

Additionally, such funds are required to disclose certain information to investors pursuant to the rules of the AIFMD and inform investors of any changes thereto. The AIFMD imposes rules on preferential treatment of investors and disclosure thereto, and the valuation of an AIF's assets must be carried out in accordance with such rules.

AIFMs are also required to have risk management, liquidity management and conflict of interest policies in place, all of which serve to add to the protection of investors.

Part II UCIs must, in addition, produce a half-yearly report for submission to the CSSF.

All of the regulated funds are subject to regular reporting to the CSSF, to enable it to carry out its supervisory function.

In the case of a dispute with a Part II UCI, a retail investor can request the CSSF to impartially intervene for an out-of-court resolution, though its out-of-court decision is not binding on the parties.

In accordance with CSSF Circular 24/856, which replaces CSSF Circular 02/77 from 1 January 2025, AIFs that are regulated entities must have in place policies and procedures to deal with net asset value (NAV) calculation errors, investment breaches and other errors. Such policies and procedures are in place to ensure protection of investors in the case of errors and the correction of such errors.

2.3.11 Approach of the Regulator

The CSSF takes a practical approach. They can be approached for face-to-face meetings, particularly in relation to a new entry to the market or in relation to new projects. As regards ongoing matters, they can be reached by phone or email. The CSSF has also set up an electronic platform to facilitate the exchange of documents and information.

2.4 Operational Requirements

See **2.3 Regulatory Environment** for further discussion on investment restrictions, borrowing restrictions and risk diversification rules applicable to Luxembourg AIFs.

AIFs managed by a fully authorised AIFM, and SIFs, SICARs and Part II UCIs that do not have an AIFM, must appoint a depositary acting in the interests of investors and providing services as required by the respective product laws as well as the AIFM Law (ie, safekeeping of assets, cash monitoring and monitoring of compliance with the legal and regulatory framework). Depositaries must be credit institutions established in Luxembourg and have a specific licence granted by the CSSF in order to carry out such business or be so-called depositary-lites, which may be appointed for certain types of AIFs that do not hold financial instruments and must be held in custody.

AIFs must have an AML policy and comply with the AML Law for their business relationships (including for their investors).

Asset valuation of AIFs must be done in accordance with the laws applicable to them, as well as in accordance with the AIFM Law where the AIFs are managed by a fully authorised AIFM.

In accordance with CSSF Circular 24/856, AIFs that are regulated entities must have in place policies and procedures to deal with NAV calculation errors, investment breaches and other errors.

2.5 Fund Finance

Luxembourg AIFs frequently borrow either for bridging finance, working capital purposes or, in the case of some funds, leverage.

While there are lenders on the Luxembourg market, lenders are often from outside Luxembourg.

There are no borrowing restrictions applicable to SIFs, SICARs, RAIFs or SLPs, though pursuant to the AIFMD there are rules around disclosing the maximum amount of leverage. Part II UCIs are subject to borrowing restrictions (generally 25% of NAV, though in the case of hedge funds this can be increased).

The lender will generally take security. The type of security will depend on the type of borrowing and types of assets involved. Security over undrawn commitments and pledges over Luxembourg bank accounts are often seen.

2.6 Tax Regime

Part II UCI, SIF and RAIF-SIF

The Part II UCI, SIF and RAIF-SIF are exempt from net wealth tax, municipal business tax and corporate income tax. Luxembourg withholding tax does not apply to distributions made by the SIF to investors. These entities also benefit from a value added tax (VAT) exemption on management services.

A SIF and RAIF-SIF are subject to subscription tax at an annual rate of 0.01% based on their NAV. There are however several categories of exemptions. Part II UCIs are subject to a subscription tax at an annual rate of 0.05% of the NAV, reduced to 0.01% or exempted in certain conditions.

In addition, the SIF, RAIF-SIF and Part II UCI in the form of a SICAV or SICAF may benefit from the double tax treaties that have been concluded by Luxembourg. The SIF, RAIF-SIF or Part II UCI in the form of an FCP do not, in principle, have access to double tax treaties.

To encourage investment into ELTIFs, the Law of 21 July 2023 modernising the Luxembourg fund toolbox (the "Modernising Law") provides that RAIFs, Part II UCIs and SIFs (or sub-funds thereof) authorised as ELTIFs are exempt from subscription tax.

SICAR and RAIF-SICAR

The tax regime applicable to a SICAR and a RAIF-SICAR will depend on the legal form adopted. Those taking a corporate form are fully taxable entities (corporate income tax and municipal business tax) but benefit from an exemption for income derived from transferable securities and income from cash held for a maximum period of one year prior to its investment in risk capital. Those taking the form of an SCS or SLP are tax-transparent under Luxembourg law.

Luxembourg withholding tax does not apply to distributions made by these entities to investors. These entities also benefit from a VAT exemption on management services.

The SICAR and RAIF SICAR are not subject to an annual subscription tax. They are however subject to a minimum amount of annual net wealth tax.

SICARs and RAIF SICARs in corporate form have full access to double tax treaties from a Luxembourg perspective. Those in the form of SLPs, or SCSs and RAIFs in the form of an FCP, do not.

SLP

An SLP is tax-transparent and is not subject to subscription tax, net wealth tax or withholding tax. Corporate income tax is not applicable. Municipal business tax of 6.75% (for an SLP registered in Luxembourg City) may be applicable if the SLP carries out, or is deemed to carry out, a commercial activity.

SLPs do not benefit from the EU Parent-Subsidiary Directive and have no access to double tax treaties signed by Luxembourg.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

UCITS funds and undertakings for collective investment subject to Part II of the UCI Law (Part II UCIs – together with UCITS funds, the "retail funds") are the two main investment funds for retail investors.

Retail funds are subject to direct supervision by the CSSF and require prior CSSF approval before they can be set up.

A retail fund may be set up as a standalone fund or an umbrella fund. However, the umbrella fund structure is most often used as it is cost-effective if several sub-funds are launched.

Each retail fund may issue classes and sub-classes of shares (or units depending on the legal form chosen; see **3.2.2 Legal Structures Used by Fund Managers**), enabling the retail fund's shares to be adapted to the needs of its investors and its sponsor.

UCITS Funds

UCITS funds are highly regulated investment vehicles that can be easily marketed to retail investors in the EEA thanks to the EU passport, but also to professional and institutional investors.

Stringent diversification rules are laid down by the UCI Law. In particular, a UCITS fund may invest no more than 10% of its assets in transferable securities (which must be listed on a regulated market) or money market instruments issued by the same body, and specific restrictions apply to index funds, holdings of other funds, use of financial derivative instruments and deposits. Leverage is restricted, and a UCITS fund must be an open-ended fund – ie, investors must be able to redeem.

Part II UCIs

Although Part II UCIs always qualify as AIFs, they are open to retail investors.

Part II UCIs are subject to a less stringent diversification policy than UCITS:

- they may borrow money or securities (up to 400% of the NAV for Part II UCIs following alternative investment strategies);
- they can be closed or open-ended funds; and
- they can be used to invest beyond transferable securities (private equity, real estate, etc).

However, Part II UCIs remain subject to the supervision of the CSSF.

Part II UCIs are not entitled to the European UCITS passport for distribution to retail investors in the EEA, but they can rely on the AIFMD marketing passport if they fall under the scope of the full AIFMD regime.

3.1.2 Common Process for Setting Up Investment Funds

Retail funds must be authorised and supervised during their lifetime by the CSSF.

A retail fund set up in contractual form as an FCP shall only be authorised if the CSSF has approved its management company, which must be based in Luxembourg.

A retail fund set up in corporate form and appointing a management company or AIFM shall only be authorised if the CSSF has approved the management company or AIFM (if a Luxembourg entity), or if the relevant management company or AIFM has notified pursuant to the management passport. Where the management company or AIFM delegates portfolio management, the entity to whom they have delegated is subject to the approval of the CSSF.

Directors (who must be of sufficiently good repute and be sufficiently experienced) and other service providers of retail funds are subject to the approval of the CSSF.

The application is carried out online on a CSSF portal and requires the provision of, inter alia, the following documents:

- an application questionnaire;
- draft instruments of incorporation;
- a draft prospectus;
- a draft PRIIPs KID or, in the case of UCITS funds exclusively distributed to professional investors, a UCITS key investor information document (KIID);
- key policies (generally already in place within the investment fund manager);

- various AML documents;
- confirmation letters regarding main service provider agreements;
- information on the directors of the fund in question; and
- a business plan.

Once the application is complete, the authorisation process for a retail fund will range between three and six months. The actual length and cost depend mainly on the complexity of the investment strategy, the completeness of the application file and whether or not it is a first-time fund.

The largest set-up costs are generally legal fees, though service providers also sometimes charge a set-up or onboarding fee. In addition, there are fees payable to the CSSF for regulated funds. The CSSF charges an examination fee and an annual fee for its supervisory activity of retail funds. The fee amount differs depending on whether the retail fund is a standalone or an umbrella fund, and on whether it is self-managed or not. For example, the examination fee for a standalone retail fund is EUR4,650, whereas for an umbrella fund it is EUR9,250.

3.1.3 Limited Liability

Regardless of the legal form or structure, investors in retail funds are only liable up to the amount of their contributions.

3.1.4 Disclosure Requirements

UCITS Funds

UCITS funds must publish a prospectus that includes the information necessary for investors to be able to make an informed investment decision and containing at least the information listed in Schedule A of Annex I of the UCI Law, as well as information about the remuneration policy. The prospectus must be kept up to date.

In addition, a three-page PRIIPs KID (or a two-page KIID under UCITS Directive 2009/65 for UCITS funds exclusively distributed to professional investors) summarising the key elements of the prospectus must be issued and kept up to date.

The following reports must be produced:

- annual report;
- semi-annual report covering the first six months of the financial year;
- semi-annual risk report (only intended for the CSSF);
- monthly financial report (only intended for the CSSF); and
- annual long-form report (only intended for the CSSF).

Part II UCIs

As with UCITS, Part II UCIs must also publish a prospectus that includes the information necessary for investors to be able to make an informed investment decision and containing at least the information listed in Schedule A of Annex I of the UCI Law. The prospectus must be kept up to date.

In addition, a three-page PRIIPs KID summarising the key elements of the prospectus must be issued if the Part II UCI is marketed to retail investors.

The following reports must be produced:

- annual report;
- semi-annual report covering the first six months of the financial year;
- semi-annual risk report (only intended for the CSSF);
- monthly financial report (only intended for the CSSF); and

- annual long-form report (only intended for the CSSF).

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

The majority of retail fund investors are located outside Luxembourg.

All types of investors invest in retail funds (retail, professional and institutional investors).

3.2.2 Legal Structures Used by Fund Managers

Usually, a retail fund is set up in the contractual form of an FCP or a SICAV (ie, a corporate entity with variable capital). UCITS funds that are SICAVs have to take the form of an SA. However, the Modernising Law has extended the choice of legal forms for Part II UCI to include not only entities in the form of an SA but also those in the form of an SCA, SCS, SCSp, *société coopérative* organised as an SA or Sàrl. In the case of a Part II UCI, it is also possible to opt for an investment company with fixed capital (SICAF) in any of the same corporate forms.

3.2.3 Restrictions on Investors

There are no restrictions – all investors (ie, retail, professional and institutional investors investing for their own account and/or on behalf of retail investors) can invest in retail funds.

Non-Luxembourg investment funds that do not qualify as UCITS funds can be marketed to retail investors in Luxembourg provided that the provisions of CSSF Regulation 15-03 are complied with and the CSSF has authorised them; if such funds qualify as ELTIFs, CSSF Regulation 15-03 does not apply but rather the rules applicable under the ELTIF regulation.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

UCITS Funds

Eligible assets are restricted to transferable securities admitted on a regulated market, investment funds, financial derivative instruments, cash and money market instruments.

Risk diversification requirements for UCITS funds include the following:

- cannot invest more than 10% of assets in transferable securities or money market instruments issued by the same issuer, and those holdings that exceed 5% cannot in aggregate exceed 40% of their assets;
- cannot invest more than 20% of assets in deposits made with the same body; and
- global exposure relating to financial derivative instruments cannot exceed the total value of the portfolio.

A UCITS fund cannot borrow more than 10% of its assets on a temporary basis.

Uncovered short positions are not allowed, but a UCITS fund can pursue a long-short investment strategy and achieve short exposure synthetically through the use of financial derivative instruments.

Various liquidity monitoring requirements are provided for.

Part II UCIs

The Part II UCI is subject to investment restrictions and risk diversification rules arising from the UCI Law and various implementing CSSF circulars. For example, generally a Part II UCI cannot:

- invest more than 10% of its assets in securities that are not listed on a stock exchange and are not traded on another regulated market that operates regularly and is recognised and open to the public;
- acquire more than 10% of the same type of securities issued by the same issuing body; and
- invest more than 20% of its net assets in securities issued by the same issuing body.

These general investment restrictions do not apply to Part II UCIs that are fund-of-fund structures, if the investment funds in which the Part II UCI shall invest are open-ended and themselves subject to similar general investment restrictions. In addition, these general investment restrictions do not apply to Part II UCIs that are either mainly investing in venture capital or real estate or are pursuing alternative investment strategies.

Part II UCIs may in principle borrow the equivalent of up to 25% of their net assets without restriction as to the intended use thereof.

Part II UCIs that are mainly investing in real estate may borrow the equivalent of up to an average of 50% of the valuation of all their properties.

Borrowings of Part II UCIs that are mainly pursuing alternative investment strategies (hedge funds) may be up to 400%.

3.3.2 Requirements for Non-Local Service Providers

The depositary, administrative agent, registrar and transfer agent, and approved statutory auditor of a retail fund must be established in Luxembourg and are all subject to regulation in Luxembourg.

The management company of a UCITS fund can be established in the EEA unless the fund is an FCP, in which case the management company must be established in Luxembourg. The AIFM of a Part II UCI can be established in the EEA unless the Part II UCI is an FCP, in which case the AIFM must be established in Luxembourg.

Portfolio managers and investment advisers located in third countries can provide advisory or portfolio management services, but this is subject to the CSSF's authorisation of any delegated portfolio management function.

3.3.3 Local Regulatory Requirements for Non-Local Managers

UCITS funds in the form of an FCP must have their management company established in Luxembourg. The same applies to Part II UCIs established in the form of an FCP.

UCITS funds that are SICAVs and are not self-managed may have their management company established elsewhere in the EEA.

An AIFM from any jurisdiction in the EEA can be appointed to manage a Part II UCI unless the Part II UCI is an FCP. Those AIFMs established elsewhere than in Luxembourg need to notify their home supervisory authorities of their intention to manage a Luxembourg fund. Those authorities will in turn notify the CSSF.

The portfolio management of Luxembourg retail funds can be delegated to managers situated in third countries provided that such delegation is subject to the prior approval of the CSSF.

3.3.4 Regulatory Approval Process

For retail funds, the process for obtaining regulatory approval depends on the complexity of the investment policy, the completeness of the file that has been submitted and whether or not it is a first-time fund. Generally, the time ranges from three to six months.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Pre-marketing to Luxembourg retail investors is not allowed for UCITS funds and AIFs.

3.3.6 Rules Concerning Marketing of Retail Funds

No notification or authorisation is required for the marketing of Luxembourg UCITS funds or Part II UCIs in Luxembourg.

A UCITS fund located in another EEA country may be marketed in Luxembourg as soon as the home supervisory authority has duly notified the CSSF of the intended marketing. Such EEA UCITS funds must provide facilities in Luxembourg to facilitate the processing of subscription and redemption orders, and the provision of information. They need not appoint a third party or have a physical presence in Luxembourg (ie, facilities can be provided via the internet).

An AIF located in a country other than Luxembourg may be marketed to Luxembourg retail investors in accordance with the provisions of CSSF Regulation 15-03, provided that, inter alia:

- it is subject to ongoing supervision by its home supervisory authority;
- it has obtained the authorisation of the CSSF for such marketing;
- its NAV is calculated at least once a month; and
- it follows certain risk diversification principles.

Retail funds and AIFs marketed in Luxembourg to retail investors must provide these investors with a PRIIPs KID.

All marketing communications will need to comply with the requirements of Article 4 of Regulation 2019/1156 on facilitating cross-border distribution of collective investment undertakings. CSSF Circular 22/795 requires investment fund managers to provide the CSSF with information regarding marketing communications. The CSSF will conduct testing to verify the compliance of such marketing communications with the requirements applicable under Article 4.

Closed-ended funds marketed to Luxembourg retail investors must generally issue a prospectus in accordance with EU Regulation 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

3.3.7 Marketing of Retail Funds

Retail funds can be marketed to all investors located in Luxembourg, whether retail, professional or institutional.

However, a number of rules stemming from the MiFID may nevertheless restrict the marketing of retail funds through MiFID-regulated firms, as the investor profile of a retail investor must be in line with the type of retail fund being marketed (eg, it is not appropriate to advise a retail investor with a conservative risk profile to invest in a fund presenting higher risk).

3.3.8 Marketing Authorisation/Notification Process

Notification or authorisation is required by the CSSF prior to the marketing of non-Luxembourg retail funds taking place.

In the case of cross-border marketing of a UCITS fund, the notification process described in the foregoing must be complied with, and in the case of marketing a foreign investment fund that is not a UCITS fund, there is an authorisation process to be complied with in accordance with CSSF Regulation 15-03.

3.3.9 Post-Marketing Ongoing Requirements

Change in the Content of the UCITS Fund Marketing Notification Letter

Where an amendment has an impact on the notification letter sent to the CSSF via the UCITS fund's home supervisory authority, at the time when the UCITS fund intended to market its units in Luxembourg or regarding a change in the share classes to be marketed in Luxembourg, the UCITS fund must directly inform the CSSF before implementing this amendment.

De-Notification

Investment fund managers may de-notify arrangements made for marketing as regards units or shares of some or all of their UCITS funds and/or AIFs marketed in Luxembourg, provided that:

- a blanket offer is made to repurchase or redeem, free of any charges or deductions, all such units or shares held by Luxembourg investors;
- the intention to terminate arrangements made for marketing such units or shares is made public by means of a publicly available medium; and
- any contractual arrangements with financial intermediaries or delegates are modified or terminated with effect from the date of de-notification, in order to prevent any new or further direct or indirect offering or placement of such units or shares.

The de-notification procedure is carried out through the home supervisory authority, which then informs the CSSF. However, if an AIFM intends to cease the marketing of its non-Luxembourg AIF to retail investors in Luxembourg, it must inform the CSSF as to whether Luxembourg investors are still invested in this AIF.

Other Ongoing Requirements

Please refer to **3.3.10 Investor Protection Rules** regarding reporting and other requirements.

3.3.10 Investor Protection Rules

To ensure compliance with the regulatory framework and to detect any potential non-compliance, retail funds must produce the following reports:

- an audited annual report;
- an unaudited semi-annual report covering the first six months of the financial year;
- a report in the case of NAV calculation error or non-compliance with applicable investment rules (only intended for the CSSF);
- a monthly financial report (only intended for the CSSF); and
- an annual long-form report (only intended for the CSSF).

In addition, UCITS funds must provide the CSSF with a semi-annual risk report, and their management companies must have a remuneration policy and procedures designed to prevent conflict of interests and discourage risk-taking inconsistent with the risk profile of the managed UCITS fund.

Furthermore, retail funds must appoint a custodian bank acting in the interests of investors and providing services as required by the UCI Law – ie, safekeeping of assets, cash monitoring and monitoring of retail funds' compliance with the legal and regulatory framework. The appointment of a custodian bank is ultimately intended to ensure protection of the fund's assets.

In the case of a dispute with a retail fund, a retail investor can contact the CSSF in order for the CSSF to impartially intervene for an out-of-court resolution, but its out-of-court decision is not binding on the parties.

Finally, NAV calculation errors and investment breaches are highly monitored by auditors and the CSSF, and incoming and redeeming investors are to be compensated in the case of negative consequences of such errors. CSSF Circular 24/856 sets out the rules to be followed in this regard from 1 January 2025.

3.3.11 Approach of the Regulator

The CSSF takes a practical approach. New Luxembourg market participants can have a face-to-face meeting with CSSF officials to present their projects, better understand the CSSF's expectations and ask questions.

Formalities and filings with the CSSF are mainly done through an online platform, though during an authorisation process, the CSSF can be contacted via telephone and email.

3.4 Operational Requirements

Retail Funds

Please refer to **3.1.4 Disclosure Requirements** and **3.3.1 Regulatory Regime** regarding investment restrictions on retail funds.

Retail funds must appoint a custodian bank acting in the interests of investors and providing services as required by the UCI Law – ie, safekeeping of assets, cash monitoring and monitoring of retail funds' compliance with the legal and regulatory framework. Custodian banks must be credit institutions established in Luxembourg and have a specific licence granted by the CSSF in order to carry out this business.

Retail funds admitted to trading on the Luxembourg Stock Exchange are subject to the Law of 11 January 2008 on transparency requirements (implementing Directive 2004/109/EC of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC), and to the Law of 23 December 2016 on market abuse (stemming from Regulation (EU) No 596/2014 of 16 April 2014 on market abuse).

Retail funds must have an AML policy and comply with the AML Law with respect to their business relationships (including their investors). In addition, each retail fund has to have in place policies to deal with NAV calculation errors, investment breaches and other errors as referred to in **3.3.10 Investor Protection Rules**.

UCITS Funds

Asset valuation of a UCITS fund must be done in accordance with the UCI Law, which provides that listed securities should be valued at the last known stock exchange quotation unless not representative. Non-listed securities or listed securities for which the market price is not representative should be valued on the basis of the probable realisation value.

Management companies must have policies in place to prevent insider dealing and the misuse of confidential information by one of their employees or service providers.

Uncovered short positions are not allowed, but a UCITS fund can pursue a long-short investment strategy and achieve short exposure synthetically through the use of financial derivative instruments.

Part II UCIs

Asset valuation of Part II UCIs must be done in accordance with the UCI Law (which provides that the valuation must be based on fair value unless the constitutional documents provide otherwise). Part II UCIs also need to value assets in compliance with the AIFM Law if managed by an authorised AIFM.

Authorised AIFMs of Part II UCIs must have policies in place to prevent insider dealing and the misuse of confidential information by one of their employees or service providers.

Part II UCIs may have uncovered short positions.

3.5 Fund Finance

UCITS Funds

A UCITS fund may borrow (i) on a temporary basis provided that such borrowing represents no more than 10% of its assets, or (ii) to enable the acquisition of immovable property essential for the direct pursuit of its business and representing no more than 10% of its assets. Borrowing under (i) and (ii) shall not exceed 15 % of its assets in total. Generally, borrowing is used to finance redemption requests, not to invest.

UCITS funds may invest in derivative financial instruments, which can provide leverage, and can enter into back-to-back loans to acquire foreign currencies.

For the foregoing transactions, a UCITS fund may provide security, such as a pledge on the securities it owns, as collateral.

Securities lending transactions, as well as repurchase agreement transactions and reverse repurchase agreement transactions, can only be used by UCITS funds for the purpose of efficient portfolio management.

Part II UCIs

A Part II UCI may borrow money or securities up to 25% of its NAV on a permanent basis. However, this cap may increase depending on the investment strategy, being:

- 200% of its NAV for alternative investment strategies; and
- 400% of its NAV for alternative investment strategies with a high level of correlation between long positions and short positions.

A Part II UCI may invest in derivative financial instruments, which can provide leverage, but it cannot borrow to finance margin deposits.

A Part II UCI is authorised to enter, as a borrower, into securities lending transactions with first-class professionals specialised in this type of transaction.

For the foregoing transactions, a Part II UCI may pledge its own securities as collateral.

Equity bridge financing can be used if the Part II UCI in question operates on a commitment basis.

3.6 Tax Regime

UCITS funds and Part II UCIs are exempt from net wealth tax, corporate income tax and municipal business tax. UCITS funds and Part II UCIs are subject to an annual subscription tax of 0.05% of the NAV (paid quarterly), reduced to 0.01% in certain specific cases-

The Modernising Law amended the UCI Law by regulating a full exemption for the subscription tax stated in the new Article 175 for:

- those UCITS funds dedicated to the pan-European personal pension product (PEPP),

which is a long-term, individual, non-occupational personal pension product (third-pillar pension) subscribed to on a voluntary basis by so-called PEPP savers to provide supplementary income on retirement, created per Regulation (EU) 2019/1238 on a pan-European personal pension product ("PEPP Regulation"), which entered into application on 22 March 2022 and by which the Luxembourg congress on 4 March 2022 enacted the Law of 25 February 2022, which lays down certain rules on, among other things, the PEPP Regulation;
- those UCITS funds, as well as individual compartments of UCITS funds with multiple compartments, (i) whose securities are reserved for institutional investors, (ii) which are authorised as short-term money market funds in accordance with Regulation (EU) 2017/1131, and (iii) which have obtained the highest possible rating from a recognised rating agency – where several classes of securities exist within the UCITS fund or the compartment, the exemption only applies to classes whose securities are reserved for institutional investors; and
- those UCITS funds that are authorised as ELTIFs in accordance with Regulation (EU) 2015/760.

In addition, retail funds may benefit from reduced subscription tax rates on the portion of their net assets, or a compartment thereof, invested in economic activities that qualify as environmentally sustainable within the meaning of the Taxonomy Regulation ("qualifying activities") (Regulation (EU) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088). For instance, the tax rate is reduced to 0.04% if the retail fund invests at least 5% of its net assets in qualifying activities. Furthermore, the annual subscription tax will be reduced to zero in the case of institutional money market cash funds, special pension funds, exchange-traded funds (ETFs) and microfinance funds, and for retail funds investing in other Luxembourg funds that are already subject to a subscription tax. These exemptions apply to the whole retail fund, the sub-fund or the class of shares qualifying for the exemption.

Investors located outside Luxembourg are not subject to Luxembourg capital gains tax.

Luxembourg withholding tax does not apply to distributions made by these entities to investors. These entities also benefit from a VAT exemption on management services.

These entities may not benefit from the EU Parent-Subsidiary Directive. In addition, these entities in a corporate form may benefit from the double tax treaties that have been concluded by Luxembourg.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

At the European level, Directive (EU) 2024/927 amending the AIFMD Directive (AIFMD II) was published on 26 March 2024. It entered into force on 16 April 2024, and EU members states have two years to transpose it. The level 2 measures and guidelines are expected to be adopted during 2025 on specific topics that will have an impact on the fund regulatory environment in Luxembourg, in particular in relation to: (i) liquidity management tools, (ii) supervisory reporting, (iii) delegation, (iv) ESG, (v) leverage, (v) loan originating funds, (vi) white-labelling (or the use of third-party AIFMs/management companies), (vii) information on costs charged to investors, and (viii) alignment of the list of permitted functions/services that an AIFM/management company can perform.

On 25 October 2024, the European Commission adopted Commission Delegated Regulation (EU) 2024/2759, supplementing the revised ELTIF 2.0 regime (ELTIF RTS). The ELTIF RTS aim to make ELTIFs a more effective tool for channelling long-term investments, with a particular focus on: (i) the requirements for an ELTIF's redemption policy and liquidity management tools, (ii) proposed methods to determine the minimum percentage of liquid assets that ELTIFs can use to satisfy redemptions, (iii) the circumstances for the matching of transfer requests of units or shares of the ELTIF, and (iv) certain elements of the costs disclosure. ELTIFs authorised before 10 January 2024 (the date of entry into force of the ELTIF 2.0 regime) and opting to remain subject to the former ELTIF regime remain subject to Commission Delegated Regulation (EU) 2018/480.

Finally, at the Luxembourg level, on 11 December 2024 the Luxembourg Parliament adopted Bill of Law No 8411, introducing changes designed to make Luxembourg more attractive and more competitive, and to reduce the tax burden on individuals. This law amended Articles 175 and 176 of the UCI Law to grant an exemption from the annual subscription tax for actively managed UCITS ETFs. The provisions of the law relating to the subscription tax exemption will apply from the first day of the quarter following the publication of the law in the *Luxembourg Official Journal*. This measure aims to strengthen Luxembourg's position as Europe's leading hub for traditional investment funds by making it more competitive and appealing in the growing European and international UCITS ETF markets.

Trends and Developments

Contributed by:
Claire Guilbert, Geoffroy Hermanns and Cyril Clugnac
Norton Rose Fulbright

Norton Rose Fulbright is a global law firm that provides a full business law service and has more than 3,500 lawyers and other legal staff based in Europe, the United States, Canada, Latin America, Asia, Australia, the Middle East and Africa. The firm's Luxembourg investment funds practice is well regarded in the market, providing high-quality and tailored legal advice on the full spectrum of investment funds law including the latest regulations, innovations, market practises and trends. It has deep experience in alternative investment funds, mutual funds, ETFs, hedge funds and related fund- and asset-management matters. The firm is a trusted counsel to international and national clients, including asset managers, institutional and professional clients, banks, non-profit organisations, venture capital firms, family offices/high net worth individuals and pension funds. Its investment funds team works closely with its global tax team, advising on the tax aspects of the structuring of funds, investment into funds and related international tax implications.

Authors

Claire Guilbert is an investment management and investment funds partner at Norton Rose Fulbright based in Luxembourg. She co-heads the firm's global funds and asset management practice and leads its internal global asset management regulation workstream. Claire advises local and international asset managers on the structuring, formation, offering and organisation of regulated and unregulated investment funds, with a particular focus on private equity, venture capital, debt and real estate strategies. She also addresses all regulatory questions related to alternative investment funds, their managers and their service providers, having particularly deep knowledge of the European and Luxembourg product laws and regulations.

Geoffroy Hermanns is a funds partner specialised in asset management and regulatory with close to two decades of experience. Geoffroy advises both GPs and LPs from the world's leading financial institutions, private equity firms, sovereign wealth funds and DFIs on the structuring and formation of a wide range of Sharia-compliant and conventional investment funds, both closed-ended and open-ended (including public UCITS-type funds and hedge funds). His experience spans across a variety of sectors with a particular focus on private equity and VC, infrastructure (renewables, ESG), real estate, digital assets and FinTech.

Cyril Clugnac is an investment funds senior associate based in Luxembourg. Cyril assists local and international asset managers in the structuring, setting up, day-to-day operations, restructuring and liquidation of Luxembourg regulated (SIFs) and unregulated (RAIFs and SLPs) alternative investment fund structures (including related non-AIF vehicles). He also assists with all regulatory aspects linked to these structures, including anti-money laundering compliance, sustainability-related disclosures in the financial services sector, cross-border marketing and the pre-marketing of funds. Cyril has particular knowledge of Luxembourg product laws and EU regulations, including AIFMD, SFDR and CBDF.

Norton Rose Fulbright

16 Boulevard Royal
L-2449
Luxembourg

Tel: +352 285 7391
Fax: +352 285 739 201
Email: alfia.sadykova@nortonrosefulbright.com
Web: www.nortonrosefulbright.com

NORTON ROSE FULBRIGHT

LUXEMBOURG TRENDS AND DEVELOPMENTS

Contributed by: Claire Guilbert, Geoffroy Hermanns and Cyril Clugnac, **Norton Rose Fulbright**

Introduction

As expected, 2024 proved as busy as the previous year on the regulatory front. Several industry-shaping regulatory projects that were in the pipeline for some time reached fruition during 2024, so much so that we will only be able to focus on a few of those in this edition of Norton Rose Fulbright's annual update. Many of these new regulations are set to come into full force (or close) in 2025. Although the industry has been preparing for these regulations ahead of their implementation, there is a big difference between theory and reality when it comes to applying EU-spanning regulatory frameworks in a fluid industry such as the investment funds industry. Hence, we expect to see interesting challenges for the industry and (hopefully) useful guidance on the regulatory front over 2025.

Trends

Farewell AIFMD, welcome AIFMD 2

Following several years of legislative process, the final legislative text of the long-awaited European Directive (Directive (EU) 2024/927 of 13 March 2024 – the Final Text), amending Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers (AIFMs) (AIFMD) and its associated annexes (the revised AIFMD, AIFMD 2) and Directive 2009/65/EC of 13 July 2009 on Undertakings for Collective Investment in Transferable Securities (UCITS) (UCITS Directive), has been published in the Official Journal of the EU (on 26 March 2024) and subsequently entered into force (on 15 April 2024), proposing a series of targeted amendments to the AIFMD and the UCITS Directive.

EU member states are required to implement such changes into their own laws within two years from the entry into force of the Final Text.

Focusing here on AIFMD 2, the key changes will be around the governance of AIFMs, loan originating funds (LOFS; with, amongst others, rules around closed- versus open-ended funds, leverage and risk retention), delegation, reporting and disclosure requirements, requirements around fund expenses, tax and AML requirements for third-country entities.

The European Securities and Markets Authority (ESMA) has been tasked with drafting technical standards and guidelines to implement some of the new rules (eg, the AIFMD 2 expansion of the existing liquidity requirements for AIFMs managing open-ended alternative investment funds (AIFs)) (with deadlines spanning from April 2025 to 2027).

One of the most discussed novelties of AIFMD 2 is the creation of a framework applicable specifically to AIFs that originate loans as the principal investment strategy (LOFs), hence regulating the underlying product through their managers.

The end goal of that new LOF regime is worthy, though: facilitating private credit activity in Europe by adding loan origination to the list of permitted ancillary activities an AIFM may undertake under its EU-wide AIFMD management passport. But while the recitals to the Final Text suggest the intention to create such a cross-border lending passport, it lacks explicit operative provision to this effect, and it remains to be seen throughout the transposition period of the Final Text how each member state's legislator will effectively facilitate the activity in its jurisdiction.

In the meantime, some of the complex requirements under AIFMD 2 may already apply to funds qualifying as LOFs and may already raise question marks as to their interpretation and practical implementation (in particular around the leverage limits and calculation as well as around the risk retention requirements).

A lot of discussions on the practicality of the new concepts that AIFMs will have to navigate can be expected in the coming years.

Finally, and as expected, the Final Text makes various amendments to the UCITS Directive for alignment with those in AIFMD 2, where relevant (save for those on LOFs, which remain reserved for AIFs).

The EU AML Package: the adventure begins

Close to three years after its unveiling, the last three pillars of the European Commission's paradigm shift for combating money laundering (anti-money laundering (AML)) and terrorism financing (countering the financing of terrorism (CFT)), in the form of its ambitious legislative package to strengthen EU AML and CFT rules (the AML Package), was published in the Official Journal of the EU on 19 June 2024 following its adoption by the European Council. The aim and content of the AML Package is to remedy the gaps in the fifth AML Directive of 2018, which was not implemented equally and in full by all member states. The AML Package also seeks to address the lack of serious consequences in the event of non-compliance, the first pillar of which, Regulation (EU) 2023/1113 of 31 May 2023 on information accompanying transfers of funds and certain crypto-assets (a recast of Regulation (EU) 2015/847 of 20 May 2015 on information accompanying transfers of funds), had been already published in the Official Journal of the EU in June 2023 (together with the Markets in Crypto Assets Regulation, or MiCAR, the first package of European legislation that has been enacted to regulate cryptocurrencies and related services) and will start to apply in a few days, as of 30 December 2024.

Those three remaining pillars of the AML Package are:

- Directive (EU) 2024/1640 of 31 May 2024 on the mechanisms to be put in place by EU member states for the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (what we previously referred to as the sixth AML Directive);
- Regulation (EU) 2024/1624 of 31 May 2024 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (what we previously referred to as the EU "Single Rulebook" Regulation); and
- Regulation (EU) 2024/1620 of 31 May 2024 establishing the Authority for Anti-Money Laundering and Countering (AAMLC) the Financing of Terrorism.

Both the sixth AML Directive and the EU Single Rulebook Regulation came into force 20 days after their publication in the Official Journal of the EU. In terms of application, the sixth AML Directive will have to be transposed into local law by EU member states by 10 July 2027 (at which point the current fouth AML Directive, as amended by the sixth AML Directive, will be repealed), with some items of this sixth AML Directive being subject to earlier transposition deadlines (ie, with respect to the beneficial owner register) and one being subject to a later transposition deadline (ie, with respect to a single access point for real estate information). The EU Single Rulebook Regulation will apply from 10 July 2027 (except for some football-related provisions, which will come into effect at a later date).

One of the most significant changes of the AML Package is the creation of the AAMLC and its ambition of a unified AML/CFT supervisory approach. The AAMLC will seat in Frankfurt and Main in Germany and assume most of its tasks and powers by 1 July 2025, although its direct supervision power will only commence in 2028.

Preparing the Digital Operational Resilience Act

The innovative regulatory framework addressing the risks posed by the digital transformation of financial services (as well as the increase in volume and severity of cyber-attacks within the sector), the Digital Operational Resilience Act – known under the widely used acronym DORA (ie, Regulation (EU) 2022/2554 of 14 December 2022) – entered into force on 16 January 2023 and is fast approaching the start of its application (and enforcement) period, commencing on 17 January 2025.

DORA has required a long preparation period for all in-scope entities as well as deep fine-tuning by the European Supervisory Authorities (ESAs), which culminated with the adoption by the European Commission, on 23 October 2024 and 24 October 2024, of regulatory technical standards (RTS) and implementing technical standards (ITS) based on the ESAs' draft published earlier this year (through two delegated regulations supplementing DORA), namely:

- an RTS specifying the content and time limits for the initial notification of, and intermediate and final report on, major information and communication technology (ICT)-related incidents, and the content of the voluntary notification for significant cyberthreats;
- an accompanying ITS regarding the standard forms, templates and procedures for financial entities to report a major ICT-related incident and provide notice of a significant cyberthreat; and
- an RTS on the harmonisation of conditions enabling the conduct of the oversight activities.

It is now up to the Council of the EU and the European Parliament to scrutinise these two delegated regulations for a maximum of three months, after which, absent objection, they will be published in the Official Journal of the EU and enter into force 20 days later.

However, the European Commission has yet to adopt two sets of RTS: the first on the criteria for determining the composition of the joint examination team and the second on thread-lead penetration testing, the ESA's drafts of which were published on 17 July 2024, as well as one set of ITS on the register of information (which is likely to stem from the expressed divergences concerning the latter between the ESAs and the European Commission regarding the inclusion of a European unique identifier for financial entities, where the European Commission seems to still favour the more traditional legal entity identifier (LEI) code, at least as an option, when identifying ICT third-party service providers registered in the EU).

The European long-term investment fund RTS finally cross the line

On 19 July 2024, a rarely seen ping-pong match between ESMA and the European Commission on the draft RTS under version 2.0 of Regulation (EU) 2015/760 on European long-term investment funds (ELTIFs) (as amended by Regulation (EU) 2023/606 of 15 March 2023 – ie, ELTIF 2.0), came to an end.

The legislative process between ESMA and the European Commission has been unusually lengthy. It started in December 2023 with the first version of the RTS published by ESMA, upon which both institutions kept passing the buck, with the European Commission giving ESMA an unusual six-week ultimatum to amend its draft to address the European Commission's concerns (in particular the need to provide ELTIF managers with greater flexibility in terms of liquidity management). This was followed by the publication of an ESMA opinion in April 2024 setting out a number of changes to the draft RTS, and the European Commission circulating in essence its own draft for internal consultation, which was finally approved in July 2024. With the lapse of the three-month scrutiny period, the RTS were published in the Official Journal of the EU on 25 October 2024 in the form of Commission Delegated Regulation (EU) 2024/2759 of 19 July 2024 (the ELTIF 2.0 RTS) and came in force the day after. The ELTIF 2.0 RTS supplement Articles 9(3), 18(6), 19(5), 21(3) and 25(3) of ELTIF 2.0, bringing much needed specifications concerning their application.

The two core subjects dealt with by ELTIF 2.0 are liquidity and redemption. Under ELTIF 2.0, an ELTIF manager may permit investors to redeem their participation during the life cycle of the ELTIF under certain conditions, provided that the manager demonstrates that the ELTIF has an "appropriate redemption policy and liquidity management tools that are compatible with the long-term investment strategy of the ELTIF" and that it provides a list of information to the competent authority of the ELTIF at the time of authorisation, as listed in Article 4 of the ELTIF 2.0 RTS. While the ELTIF 2.0 RTS do not specify the length of the minimum holding periods prior to redemption requests, they do require the ELTIF manager to determine a minimum holding period based on:

- the long-term nature and investment strategy of the ELTIF;
- the ELTIF's underlying asset classes, their liquidity profile and their position in the life cycle;
- the ELTIF's investment policy; and
- the ELTIF's investor base.

Furthermore, the maximum percentage of liquid assets that can be used for redemption requests is required to be calibrated by the ELTIF manager at its discretion, on the basis of one of two sets of factors set out in the ELTIF 2.0 Annexes (ie, on the basis of either the ELTIF's redemption frequency and notice period or its redemption frequency and minimum percentage of liquid assets).

In addition, the ELTIF 2.0 RTS define:

- the circumstances in which the use of derivatives for hedging purposes is permitted;
- the circumstances in which the life of an ELTIF can be considered compatible with the life cycles of its individual assets;
- the policy requirements for the full or partial matching of transfer requests by exiting and new investors; and
- the calculation methodologies and presentation of costs of an ELTIF.

All in all, the ELTIF 2.0 RTS tackle most of the problems raised by their first iteration, and the road is now clear for ELTIFs to move forward in their 2.0 format.

The much-needed revamp of Commission de Surveillance du Secteur Financier Circular 02/77

In 2002 – ie, more than 20 years ago, Commission de Surveillance du Secteur Financier (CSSF) established its framework on the protection of investors in case of net asset value (NAV) calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment (UCI) – under CSSF Circular 02/77 – and it has been clear that the industry evolved in different directions during this period. Many significant milestones have changed the landscape of UCI. These milestones include the implementation of Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the co-ordination of laws, regulations and administrative provisions relating to UCI in transferable securities, the implementation of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers, and the emergence of new products such as specialised investment funds (SIFs), ELTIFs, European venture capital funds (EuVECAs), the European social entrepreneurship fund (EuSEF) and money market funds (MMFs).

These new products, and the evolution of related industries in Luxembourg, came with a growing investor base, thus increasing investors' exposure to the risks and consequences of NAV calculation errors and non-compliance with the relevant investment rules for UCIs. This was something the CSSF was very aware of, resulting in it updating the CSSF Circular 02/77 framework through active communication with the industry, conducting inspections and issuing fines. But one should not forget the key aim of the framework set by CSSF 02/77, which was to ensure that investors have confidence in UCIs – something that controls, sanctions and a fragmented framework do not foster. Thus, it was time to consolidate and clarify the rules and bring more things within their scope to reflect the reality of the industry. As a result, CSSF Circular 24/856, published on 28 March 2024, sets a high bar for the industry by, among other things, approaching compliance and investor protection as a collaborative and proactive exercise that concerns all those involved with a particular UCI. It reinforces the methodologies for correction, prevention and rectification of NAV calculation errors – and for non-compliance with the investment rules and other errors (including tolerance thresholds) – and it addresses a broader spectrum of operational risks.

CSSF Circular 24/856 is also key for investors in UCIs as it provides explicit guidelines for compensation and cost bearing in relation to NAV calculation errors, non-compliance with the investment rules and other errors, including incorrect fee payments and investment allocation errors. This new Circular will certainly require UCIs to update their NAV calculation procedures, enhance their internal controls and ensure that proper internal training on these new rules is provided.

It is also important to note that, when it comes to NAV calculation errors, CSSF Circular 24/856 distinguishes between open- and closed-ended UCIs, taking into account the fact that such errors have more significance for opened-ended UCIs, which normally calculate their NAV on a daily basis, allowing investors to enter or exit on any day. CSSF Circular 24/856 does not require closed-ended UCIs to notify the CSSF of NAV calculation errors (as they are exempt though certain of the guidelines set out in Chapter 4 of CSSF Circular 24/856, which should be followed by closed-ended UCIs). However, other types of error (eg, incorrect fee payments) must be reported to the CSSF by closed-ended UCIs, and all errors (even if not reportable to the CSSF) must be corrected.

The increased oversight of NAV calculation errors, the change in rules effected by CSSF Circular 24/856 (which will come into effect on 1 January 2025) and increased scrutiny by the CSSF, coupled with an ongoing agitated economic environment, may lead to such errors being detected and reported more frequently in the future, with high levels of compensation being paid to investors when these errors are material in the spirit of ensuring investors receive due compensation and protection.

Beware "green" names for investment funds

In May 2024, ESMA published its eagerly anticipated final guidelines on using environmental, social and governance (ESG) or sustainability-related terms in fund names. In August 2024, ESMA published the official translations of the guidelines, which means that they will apply from 21 November 2024. Asset managers should therefore be taking urgent steps to ensure compliance. Investor demand for investment funds that incorporate ESG factors has grown and will continue to grow in the future. In this context, the name of a fund is important as it is usually the first attribute thereof that investors see, with the potential to have a significant impact on their investment decisions. Financial services regulators are aware of this and have concerns regarding the risks of greenwashing from this point of view. On 31 May 2022, ESMA issued a supervisory briefing on sustainability risks and disclosures in investment management (the "Briefing"), containing inter alia principles-based guidance on fund names with ESG and sustainability-related terms. The Briefing was issued under Article 29(2) of the Regulation establishing ESMA, meaning that it was intended to promote common supervisory approaches and practices, but it was not binding with member state competent authorities (national competent authorities (NCAs)) nor subjected to a comply-or-explain mechanism.

Almost six months later, ESMA followed up the Briefing with a consultation on draft guidelines on using ESG or sustainability-related terms in fund names (the "Consultation"). The draft guidelines contained more specific guidance on the issue compared to the supervisory briefing.

The Consultation closed on 23 February 2023, with ESMA expecting to issue the final guidelines relatively quickly thereafter, by Q2/Q3 2023. However, given the significant amount of feedback from the market, the publication of the final guidelines (the "Guidelines") was delayed until 14 May 2024. The Guidelines were issued under Article 16 of the Regulation establishing ESMA meaning that, unlike the Briefing, NCAs are subject to a comply-or-explain mechanism.

The Guidelines introduce quantitative thresholds (eg, the proportion of ESG-related investments and/or sustainable investments) that will apply as a condition for funds using ESG and/or sustainability related terms in their names, as well as minimum safeguards (including the exclusion criteria defined in Commission Delegated Regulation (EU) 2020/1818 of 17 July 2020), depending on the type of terms used by a fund in its name. The Guidelines apply to:

- management companies of UCITS funds within the meaning of the UCITS Directive, including UCITS funds that have not designated such management company (ie, internally managed UCITS funds);
- AIFMs within the meaning of the AIFMD, including internally managed AIFs within the meaning of the AIFMD;
- the managers of EuVECAs, EuSEFs, ELTIFs and MMFs; and

- NCAs.

There remain some uncertainties around the exact scope of application of the final guidelines, which will require further clarification by ESMA. These include:

- whether the Guidelines apply to funds that are closed to further subscription by investors, despite a majority of respondents to the Consultation being against it; and
- whether the Guidelines apply to non-EU AIFMs and non-EU AIFs – whilst non-EU AIFs managed by EU AIFMs are likely to be in scope provided that such non-EU AIFs are marketed in the EU, the situation is less clear for non-AIFMs marketing AIFs in the EU under Article 42 of the AIFMD (which requires compliance with Article 23 of the AIFMD, including Article 23(7) of the AIFMD under which ESMA based the Guidelines).

Also, in terms of scope, it is worth noting that the Guidelines do not capture all the financial products captured by Regulation (EU) 2019/2088 of 27 November 2019 (the “Sustainable Finance Disclosure Regulation” (SFDR)), which has a much broader scope, leaving a gap between the two.

As for the content of the Guidelines, funds are bracketed into three categories depending on the type of terms used in their name, with each of these categories sharing a common requirement: 80% of the relevant fund’s investments should be used to meet environmental or social characteristics, or sustainable investment objectives, in accordance with the binding elements of the investment strategy disclosed in Annexes II and III of Commission Delegated Regulation (EU) 2022/1288, which supplements the SFDR. In addition, depending on the category (or combination thereof) in which a relevant fund’s name falls, Climate Transition Benchmark (CTB) exclusions and/or Paris-Aligned Benchmark (PAB) exclusions must be applied.

On 21 August 2024, ESMA published the Guidelines on its website in all EU official languages, starting the clock as to when they apply such that:

- NCAs had until 21 October 2024 to notify ESMA as to whether they (i) comply, (ii) do not comply but intend to comply, or (iii) do not comply and do not intend to comply with the Guidelines;
- the Guidelines apply from 21 November 2024; and
- managers of new funds are expected to comply with the Guidelines in respect of those funds from the date of application – managers of funds existing before the date of application should comply with respect to those funds within six months from 21 May 2025.

Finally, it should be kept in mind that ESMA highlights in the Guidelines that “it should be noted that these guidelines have been designed in light of the current legislative framework. ESMA will review the guidelines, if necessary, in case of any update of the relevant legislation”.

In Luxembourg, the CSSF opted for the application of the Guidelines, publishing on 21 October 2024 the related CSSF Circular 24/863 and thereby implementing the Guidelines into the Luxembourg regulatory framework.

Conclusion

The fund industry is growing and evolving into a more mature industry – which is in the process of being shaped progressively by the various regulatory initiatives mentioned above – with the end goal of making the industry stronger and more harmonised.

But the fund industry is at the same time being shaken by surrounding economic and political turmoil: as ever, market players will have no choice but to continue navigating these troubled waters, which will see both challenges and opportunities. We therefore hope that the implementation of these regulatory initiatives is both pragmatic and practical.

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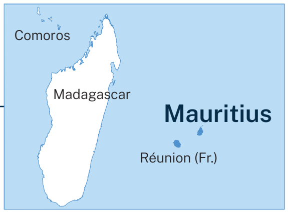

Law and Practice

Contributed by:
Bhavna Ramsurun, Pinki Mahata, Lorna Senivassen and Shreya Mungur
BLC Robert & Associates

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BLC Robert & Associates

BLC Robert & Associates is the leading independent business law firm in Mauritius, with the largest number of fee earners. The firm's membership of Africa Legal Network strengthens its position as the leading provider of legal services both locally and throughout the African continent, through the presence of member law firms in 15 African jurisdictions. BLC Robert & Associates has seven partners and four main practice areas: corporate and commercial, banking and finance, financial services and regulatory, and dispute resolution. The firm also has further specialised sub-practice groups, covering business law, M&A, employment, taxation, real estate and hospitality, insolvency, capital markets, and TMT. Clients include a vast number of funds, private equity houses, managers, insurance companies, fiduciary businesses and financial advisers. Funds and funds-related work is a core area of the practice, with a dedicated team advising on all aspects of fund formation, closings, investor relationships, regulatory, and tax structuring.

Authors

Bhavna Ramsurun is a partner at BLC Robert & Associates and specialises in financial regulatory matters, with a particular focus on investment funds, capital markets regulation, and securities law. She frequently advises on fund formation, the establishment of financial services providers and institutions, and regulatory compliance. Bhavna has represented a number of fund managers, private equity and venture capital firms, investment funds and financial institutions, as well as institutional investors. She also advises domestic and international players on their capital raising in the Mauritian market and on a cross-border basis. Bhavna is a member of the Mauritius Bar Association.

Pinki Mahata is an associate in the financial services team at BLC Robert & Associates, specialising in financial services, competition, regulatory, and compliance-related matters. She has been involved in the setting-up of a USD500 million private equity fund investing in private sector businesses domiciled in Africa, in the restructuring and setting-up of a Mauritius-domiciled real estate fund investing in real estate development in African countries with a target worth of USD450 million, in the restructuring of a Sub-Saharan investment structure, and in the restructuring of a pan-African fintech company.

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BLC Robert & Associates

Lorna Senivassen is an associate in the financial services and capital markets practice area at BLC Robert & Associates. She has been involved in the drafting of fund and other legal documentation, reviewing local and foreign law documents, and issuing legal opinions to investors. Lorna is often called upon to advise on the establishment of financial services providers and institutions, as well as on regulatory compliance matters.

Shreya Mungur is an associate in the financial services and capital markets practice area at BLC Robert & Associates, who is often called upon to advise on the setting-up of investment funds, on regulatory issues and on commercial law matters. She has also been involved in the drafting of fund and other legal documentation, reviewing local and foreign law documents, and assisting in the preparation of legal opinions for investors. Shreya is a member of the Mauritius Bar Association.

BLC Robert & Associates

2nd Floor
The Axis
26 Bank Street
Cybercity
Ebene 72201
Mauritius

Tel: +230 403 2400
Fax: +230 403 2401
Email: chambers@blc.mu
Web: www.blc.mu

BLC ROBERT & ASSOCIATES ALN

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1. Market Overview

1.1 State of the Market

Mauritius has established itself as a leading international financial services centre and has made it into the pantheon of successful developing economies by adopting international norms and best practices and promoting a business-friendly environment. The choice of Mauritius as a domicile for structuring business into Africa and Asia is well established among fund managers and institutional investors, who can benefit from the well-established and advantageous ecosystem. Mauritius has so far concluded 46 tax treaties and is a party to 29 Investment Promotion and Protection Agreements, which provide extra assurance and protection for the country's potential investors. Mauritius has always proved itself to be a jurisdiction of economic substance.

Mauritius is a recognised jurisdiction for global investment funds, with 946 funds (both open-ended and closed-end), according to statistics published by the Financial Services Commission (FSC) in 2024. Mauritius has consistently improved its position in the Global Financial Centre Index (GFCI) over the years and features as a financial centre likely to become significant according to the 36th edition of the GFCI. Mauritius had around 932 global funds as of end October 2024, as per the monthly global business data sheet issued by the FSC.

Mauritius has been at the forefront of providing innovative products and solutions to investors. The FSC is keen to develop fintech-related initiatives in Mauritius and has launched its Fintech and Innovation webpage in order to meet the diverse needs of the financial services and fintech industries. This is a comprehensive resource hub and an additional feature on the FSC website, aiming to stay abreast of new product offerings and emerging trends in the fintech ecosystem.

As an international financial centre and growing fintech hub, Mauritius was one of the first countries in the Eastern and Southern African region to adopt comprehensive legislation on virtual assets and initial token offerings – namely, the Virtual Asset and Initial Token Offering Services Act 2021 in February 2022. This statute regulates the business activities of virtual asset service providers and initial token offerings.

In addition, Mauritius is a politically stable jurisdiction whose system of law is inspired by English common law and French civil law, with a final right of judicial recourse to the Judicial Committee of the Privy Council of the United Kingdom. At the same time, it is geographically and culturally close to countries in Africa and Asia, making it a preferred platform for establishing holding structures in the emerging markets of these continents. Mauritius is a member of the Southern African Development Community (SADC), the Indian Ocean Rim Association (IORA) and the Common Market for Eastern and Southern Africa (COMESA).

Mauritius' regulatory framework provides for both retail funds and alternative investment funds (AIFs) – the latter of which are authorised as investment funds generally and further categorised as expert funds or professional collective investment schemes (professional CISs) under the laws of Mauritius. They are available only to sophisticated and expert investors and high net worth individuals, as well as being exempted from the stricter regulations applied to retail funds. Retail funds are offered to the public and are regulated as open-ended funds (known as CISs) or closed-end funds (CEFs). The FSC has also added additional fund categories such as special purpose funds and real estate investment trusts (REITs).

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Funds can be set up as companies, limited partnerships, protected cell companies (PCCs), trusts, or variable capital companies (VCCs). The typical vehicle used to structure a CEF is a company or a limited partnership, whereas a CIS is commonly structured as a company, unit trust or PCC. The new VCC structure now provides an alternative for fund structuring, giving fund managers the opportunity to operate several sub-funds (which can include a CIS and a CEF) and SPVs under an umbrella fund instead of having to set up separate structures.

Companies

Companies may be established as public or private and are incorporated under the Companies Act 2001. Participants are issued with shares of the company. A private company is limited to 50 shareholders and cannot offer shares to the public. Companies have the following features:

- they can be structured as limited life companies and/or limited by shares;
- the liability of a shareholder is limited to the extent of the amount unpaid on their shares;
- a board is subject to the doctrine of fiduciary responsibility;
- a separate legal personality is maintained; and
- statutory rules for filing and reporting ensure transparency and accountability.

Distribution to shareholders is subject to the company remaining solvent. The company is treated as one taxable unit.

Limited Partnerships

This form of partnership is governed by the Limited Partnerships Act 2011. It can be set up with or without legal personality and will have at least one general partner and one or more limited partners. The general partner is responsible for the management of the limited partnership and has unlimited liability for the debts and obligations of the partnership. The liability of the limited partner is limited to the maximum amount of its contribution, provided that the limited partner takes no part in the management of the partnership. Where the limited partner does become involved in the management of the partnership, they will be treated as a general partner and be liable for the debts of the partnership. Participants' interests are referred to as partnership interests.

A private equity fund structured as a partnership would offer the benefits of:

- relative flexibility;
- the mitigation of fiduciary risks;
- the ability to account for profits and losses at limited partner level; and
- tax transparency.

The partnership also offers limited liability to limited partners, but the liability of a general partner is not capped.

Protected Cell Companies

A PCC is subject to the Protected Cell Companies Act 1999 and the Companies Act 2001. Participants in a PCC are issued with "cell shares" in the cell in which they invest. The segregation of assets and liabilities can be achieved by using a PCC.

PCCs are often structured to meet the objectives of investment – for example, providing for investor returns from specific cells, distinct separation of non-cellular assets and cellular assets, and restricting liability arising from one cell to that cell only. PCCs have the same advantages as companies, including limited liability for shareholders, a board that has fiduciary duties, separate legal personality, and the same statutory rules for filing and reporting.

Trusts

Trusts are created under the Trusts Act 2001 and participants are issued with units therein. A trust established in Mauritius can have up to four trustees – at least one of whom should be a qualified trustee (a person who is authorised as such by the FSC).

Trusts are relatively easy to set up and are flexible vehicles, but do not have legal personality. The creation of a trust does not require any registration or incorporation – although an application to the FSC must be made in order to be authorised as a fund. Trustees are subject to fiduciary duties.

Variable Capital Companies

A VCC is incorporated under the Companies Act 2001 and carries out its activities through sub-funds and SPVs. A VCC needs to be authorised by the FSC as a "VCC fund", pursuant to the Variable Capital Companies Act 2022.

A VCC can operate as a standalone investment fund or can be structured as an umbrella fund through its sub-funds and/or its SPVs. The assets and liabilities of one sub-fund or SPV are segregated from those of another and, as such, the liabilities of a sub-fund under an umbrella VCC can only be discharged from its assets and not out of the assets of the other sub-funds or SPVs.

Unlike a PCC, one sub-fund of a VCC fund can be structured as a CIS, while another sub-fund of the same VCC fund can be structured as a CEF. Therefore, a VCC fund can accommodate both open-ended and closed-end structures under one "umbrella" structure. In addition, the sub-fund or SPV of a VCC fund may have a separate legal personality from that of the VCC fund (ie, separate name and legal entity) – in which case, it must be incorporated as a company under the Companies Act 2001. A sub-fund of a VCC fund can also act as a feeder fund or a master fund. On the other hand, SPVs can only operate as a vehicle ancillary to the VCC or a sub-fund of the VCC, and not as a fund on their own.

2.1.2 Common Process for Setting Up Investment Funds

Funds in Mauritius are regulated as CISs or CEFs and requires= fund authorisation from the FSC. AIFs are typically sub-classified as expert funds or professional CISs.

A fund that conducts business principally outside Mauritius, the majority of whose shares/voting rights/legal or beneficial interests are held by non-citizens, will also be required to apply for a global business licence (GBL). Any corporation holding a GBL must be administered by a management company that is duly licensed by the FSC (the "administrator"). Such an administrator must also be appointed as the GBL's corporation secretary/registered agent and will be responsible for liaising with the authorities on the setting-up and licensing of the entity, as well as for ensuring ongoing compliance with Mauritius' laws.

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Prior to application, the applicant will need to reserve the proposed names of the entities with the Mauritius Registrar of Companies/Registrar of Limited Partnerships (the "Registrar") and pay the relevant fee. If approved, the proposed name is valid for two months from the date of notice of reservation of the name.

In relation to the setting-up of the fund in Mauritius, the application for registration is lodged with the Registrar, who will then notify the FSC of the application through the FSC One Platform ("FSC One"). Following receipt of this notification, the application for a GBL and authorisation to operate as a fund (open-ended or closed-end) will be lodged on the FSC One.

The following documents need to be submitted for the registration and licensing of the fund:

- a duly completed application form for the registration/incorporation and licence;
- fund documents, as follows:
  (a) a constitution and the shareholders' agreement (if adopted) for a company;
  (b) a limited partnership agreement for a limited partnership;
  (c) the trust deed for a trust; and
  (d) the subscription agreement, the investment management agreement and any advisory agreement (drafts of the fund documents may be submitted, but the FSC expects these to be in near final form);
- a draft offering memorandum or prospectus;
- a consent form for initial shareholders and directors or partners;
- KYC documentation on promoters and beneficial owners as well as proposed directors, general partners or trustees (as applicable);
- certificates and confirmations required by law and the regulators;
- the appropriate government/licensing fees; and
- any additional documents the FSC might require.

The timeframe for the application for a fund authorisation is around 60 business days from the time the application is submitted to the authorities, assuming the application is complete and related queries are cleared on time.

The following fees are payable to the FSC for the licensing process:

- a registration fee for CISs (open-ended) and CEFs (for a single fund) of USD1,000 and an annual fee (payable in advance) of USD3,000;
- a registration fee for CISs (open-ended) and CEFs that are structured as umbrella funds or PCCs and have more than one fund/cell of USD1,000 for the first fund/cell and USD300 for each additional fund/cell;
- an annual fee of USD3,000 for the first fund/cell and USD600 for each additional fund/cell;
- a registration fee for CISs (open-ended) and CEFs that are structured as VCCs of USD1,000 for the first sub-fund and USD500 for each additional sub-fund or SPV;
- an annual fee of USD3,000 for the VCC (inclusive of the first sub-fund), then USD1,000 each for the second to fifth sub-funds/SPVs, and USD1,950 for each additional sub-fund or SPV;
- an annual fee of USD5,000 for a fund categorised as a special purpose fund or a REIT; and
- for the GBL, a processing fee of USD500 and an annual fee of USD1,950.

In addition to FSC fees, an incorporation fee of MUR3,000 and an annual fee of MUR9,000 are payable to the Registrar of Companies in the case of a company, and a registration fee of

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MUR3,000 and an annual fee of MUR2,500 are payable to the Registrar of Limited Partnerships in the case of a limited partnership.

2.1.3 Limited Liability

Investors typically seek participation in a structure whereby their liability is limited. These investments generally take the form of either shares in a company limited by shares or partnership interests in a limited partnership. The liability of investors will be limited to the amount they have contractually undertaken to pay to the fund.

To enjoy limited liability, the underlying principle in both structures is for the investor to have a passive participation. Investors risk losing their limited liability status if they participate in the management of the business of the fund. In doing so, they may be viewed as acting as the general partner or a director (depending on the structure) and thus attract the unlimited liability that generally attaches to a general partner, or they may become personally liable as a director.

Legal opinions on the limited liability of investors (and on matters such as due incorporation/registration and the power, capacity and authority of the fund to execute the fund agreements) are typically provided upon request by the shareholders/limited partners.

2.1.4 Disclosure Requirements

A fund authorised in Mauritius needs to file an offering document with the FSC. Any update to these documents must also be filed with the FSC. The type of offering document and the relevant disclosure in this document will vary depending on the category of the fund and the target investors.

The disclosure requirements for funds being offered by way of private placement or to sophisticated investors, high net worth investors or expert investors will be reduced. However, the offer document must contain the requisite disclaimers and generally sufficient information to allow investors to make an informed decision on investment in the fund.

Reporting Requirements

Non-retail funds are required to file audited financial statements with the regulator within six months of the balance sheet date. However, such accounts do not need to be made public.

The annual financial statements of companies/limited partnerships (other than those holding a GBL) are available for public inspection at the Registrar of Companies/Registrar of Limited Partnerships (as applicable).

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

There is a diverse range of investors in Mauritius, including institutional investors, development finance institutions, family offices and financial institutions.

2.2.2 Legal Structures Used by Fund Managers

An investment manager licensed by the FSC must:

- be incorporated or registered as a body corporate in Mauritius;
- be engaged principally in the business of managing funds;
- have directors, officers and beneficial owners who meet the “fit and proper” test;
- have appropriately qualified staff;

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- maintain a minimum stated capital of at least MUR1 million (or an equivalent amount in a different currency) at all times;
- have proper insurance cover in place;
- establish and document its rules of internal control to ensure that it is legally compliant and sufficiently supervised;
- have a code of ethics and a code of conduct in place that are binding on its officers, advisers and employees; and
- comply with AML laws.

Fund managers are typically set up as companies incorporated under the Companies Act 2001.

2.2.3 Restrictions on Investors

An expert fund is only available to:

- an investor making an initial investment on its own account of no less than USD100,000;
- a sophisticated investor (as defined in **2.3.10 Investor Protection Rules**); or
- any investor similarly defined in the securities legislation of another country.

A professional CIS is not available to the public but can be offered to sophisticated investors, as defined in the Securities Act 2005, or on a private placement basis in the case of an open-ended fund where the minimum subscription amount is at least USD200,000. For a CEF, the subscription amount is generally more than USD200,000.

To qualify as a professional CIS, the following restrictions apply:

- shares acquired by the participants may not be resold to the public and the participants are advised of this restriction at the moment of subscription; and
- the fund may not be listed for trading on a securities exchange.

A special purpose fund (which can be open-ended or closed-end) is only permitted to offer its shares by way of private placements to competent investors with significant experience and knowledge of fund investment. It can have a maximum of 50 investors and a minimum subscription of USD100,000 per investor.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

There are two main categories of funds: CISs and CEFs. As defined in the Securities Act 2005, a CIS is obliged to redeem a participant's shares at their request, at a price corresponding to the net asset value (NAV) of those investments (minus fees and commissions). This obligation does not exist for CEFs, which are characterised principally by the fact that the investors do not have control over when and how they exit the fund. A CIS or CEF is set up mainly to invest in portfolios of securities, money market instruments, or debt instruments (including loans, debt obligations or similar instruments) or other financial assets, real property or non-financial assets, subject to the approval of the FSC.

A fund is required to be managed by an investment manager licensed as a CIS manager by the FSC. A fund holding a GBL may appoint a foreign investment manager subject to the approval of the FSC. A fund that is constituted as a company may be self-managed (ie, managed by its board of directors), with the approval of the FSC.

AIFs are classified as expert funds (which must be open-ended) or professional CISs (which can be either open-ended and closed-end) and are entitled to exemptions from the following detailed regulations that apply to retail funds:

- the requirement to have a prospectus in the prescribed form (the offering memorandum can be customised subject to a few mandatory disclosure requirements);
- the minimum funding requirements;
- investment and borrowing restrictions;
- the requirement to prepare and file management reports and quarterly reports;
- the requirement to conduct daily valuations; and
- the requirement to publish the prices of interests in the CIS on a weekly basis.

To qualify for categorisation as a professional CIS, the restrictions set out under **2.2.3 Restrictions on Investors** would apply.

2.3.2 Requirements for Non-Local Service Providers

Non-local service providers cannot provide services as administrators, custodians, director services providers, etc, in Mauritius by way of business. They will need to set up either a branch or a subsidiary in Mauritius, which will need to apply for a licence from the FSC in order to conduct business in Mauritius.

Where there is no business establishment in Mauritius and the service provider does not solicit Mauritian retail investors in respect of services related to the marketing of securities, there will be no prohibition on the service provider dealing with such persons, and usually no licensing requirement will be triggered for such non-local service provider. However, depending on the services being provided and the categorisation of the fund granted by the FSC, the fund may be limited to local service providers or may require the approval of the FSC prior to the appointment of a non-local service provider.

2.3.3 Local Regulatory Requirements for Non-Local Managers

Prior FSC approval is required to appoint a foreign manager to manage a fund authorised in Mauritius. However, this option is only available where the fund holds a GBL.

The FSC will assess whether the licence of the foreign investment manager is issued by a regulatory body in a jurisdiction that has comparable regulation to Mauritius for investor protection. In support of the application for prior approval, a draft of an investment management agreement between the fund and foreign investment manager and evidence of the licensed status of the manager must be submitted to the FSC, alongside details of the management team's appropriate competence and relevant fund management experience.

2.3.4 Regulatory Approval Process

The timeframe for the application for a fund authorisation is around 60 business days from the time the application is submitted to the authorities, assuming the application is complete and related queries are cleared on time.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

The production and offering of marketing materials are regulated by the Securities Act 2005 and the regulations and rules thereunder, as well as by the FSC's Guidelines for Advertising and Marketing of Financial Products 2014. These guidelines regulate the conduct of the marketing and the content of advertisements and marketing materials. They also require certain specific disclosures and disclaimers on the product and the persons promoting them.

The regulatory framework does not provide specific rules on the pre-marketing of alternative funds; however, any fund-related document provided to investors should clearly disclose the status of such document (for instance, if it is still in draft form) and the regulatory status of the person marketing the document, as well as the regulatory statuses of the fund and the manager. Investors must be expressly informed of the foregoing and should be warned to only rely on the final constitutive documents of the fund when making any investment decision.

2.3.6 Rules Concerning Marketing of Alternative Funds

As mentioned in **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**, the production and offering of marketing materials are regulated by the Securities Act 2005 and the regulations and rules thereunder, and by the FSC's Guidelines for Advertising and Marketing of Financial Products 2014.

The law limits any solicitation to invite or induce a retail investor in Mauritius to buy, sell or exchange securities to be done solely by licensed persons. The following activities may be carried out only by locally licensed intermediaries:

- seeking to meet a retail investor at their place of residence or work or in public places;
- contacting a retail investor by telephone, letter, circular, the internet or other electronic means or telecommunications system; or
- publishing or causing an advertisement to be published or circulated by a person to induce another person to buy, sell or exchange securities or to participate in transactions involving securities, or offering such a person services, recommendations or advice for those purposes.

These guidelines regulate the conduct of the marketing and the content of advertisements and marketing materials. They also require certain specific disclosures and disclaimers on the product and the persons promoting them.

All marketing materials need to be submitted to the FSC prior to dissemination.

2.3.7 Marketing of Alternative Funds

Shares or interests in funds that are authorised as professional CISs or expert funds can only be offered to specific types of investors, as described in **2.2.3 Restrictions on Investors**.

2.3.8 Marketing Authorisation/Notification Process

As mentioned in **2.3.6 Rules Concerning Marketing of Alternative Funds**, all marketing materials need to be submitted to the FSC prior to dissemination.

A professional CIS (open-ended or closed-end) must notify the FSC 15 days before the offering is made and simultaneously file a copy of the offering document prepared for the purpose of the offering. Moreover, a professional CIS (open-ended or closed-end) is required to inform the FSC of the conclusion of an offering, indicating the total amount and value of shares sold.

2.3.9 Post-Marketing Ongoing Requirements

In Mauritius, there are no prescribed ongoing requirements for firms that have marketed an alternative fund other than the contractual obligations they have entered into and the general licensing obligations specifically applicable to them by virtue of the capacity under which they have marketed the fund.

2.3.10 Investor Protection Rules

There are specific categorisations of funds that are targeted only to specific investors and thus enjoy exemption from the regulations on the grounds that they are only offered to sophisticated, institutional or high net worth investors. "Expert funds" can only be offered to expert investors (ie, an investor that makes an initial investment for its own account and of no less than USD100,000) or sophisticated investors, as defined in the Securities Act 2005 (or any investor similarly defined in the securities legislation of another country).

Under the Securities Act 2005, sophisticated investors include the following:

- the government of Mauritius;
- a statutory authority or an agency established by an enactment for a public purpose;
- a company whose shares are wholly owned by the government of Mauritius, by a statutory authority or by an agency established by an enactment for a public purpose;
- the government of a foreign country (or an agency of that government);
- a bank (licensed by the Bank of Mauritius);
- a CIS;
- a fund manager (licensed by the FSC);
- a pension fund or its management company;
- a CEF;
- an insurer (licensed by the FSC);
- an investment adviser (licensed by the FSC);
- an investment dealer (licensed by the FSC);
- an investor that guarantees, at the time of entering into a securities transaction, that:
  (a) its ordinary business or professional activity includes entering into securities transactions, whether as principal or agent;
  (b) for a natural person, the individual net worth or joint net worth with a spouse exceeds USD1 million or its equivalent in another currency; or
  (c) it is an institution with a minimum amount of assets under discretionary management of USD5 million or its equivalent in another currency; and
- a person declared by the FSC to be a sophisticated investor.

As mentioned in **2.2.3 Restrictions on Investors**, professional CIS cannot be offered to the public and is only available to a sophisticated investor, as defined in the Securities Act 2005, or as a private placement. In the case of an open-ended fund, the minimum subscription amount must be at least USD200,000 and – for a CEF – the subscription amount is generally more than USD200,000.

Investors are not protected by any statutory compensation arrangements in Mauritius in the event of the fund's failure, and it is mandatory for the offer document to include such disclosures along with other disclosures specific to the type of fund as required by the FSC.

2.3.11 Approach of the Regulator

The FSC is mandated under the Financial Services Act 2007 to, inter alia, ensure the orderly administration of financial services and global business activities and to ensure the sound conduct of business in the financial services sector and in the global business sector. To achieve its objectives, the FSC elaborates policies that aim to ensure the fairness, efficiency, transparency and stability of the financial system in Mauritius. It also publishes monthly newsletters, FAQs and circular letters to provide regular updates and guidance. The regulator's online portal contains general information, up-to-date legislation and regulations, and statistics on licensed entities operating in Mauritius.

The FSC conducts investigations and imposes sanctions (including the revocation or suspension of licences) where it has reasonable cause to believe that a licensee is:

- committing or has committed a breach of the relevant laws; or
- carrying or has carried on an activity that may cause prejudice to the soundness, integrity and stability of the financial system of Mauritius or to the reputation of Mauritius.

Where additional information or clarifications are required by the FSC with regard to fund applications, the FSC will usually raise such queries with the administrators via email. It is also possible to request face-to-face meetings with the FSC.

2.4 Operational Requirements

There are no particular regulatory restrictions or requirements in relation to the types of investments for AIFs. Any person wishing to establish a specialised fund that invests in real estate, derivatives, commodities or any other product must apply to the FSC for a decision on whether such fund would be authorised.

An open-ended fund categorised as an expert fund or a professional CIS is required to appoint a custodian that holds a custodian licence under the Securities Act 2005 to hold and safekeep the assets of the fund. Only banks and trust companies that are subsidiaries of banks are eligible for a custodian licence. If the fund holds a GBL, it may appoint a foreign custodian with the approval of the FSC. The appointed custodian must act independently from the fund manager and the fund. However, CEFs are exempt from the requirement to appoint a custodian – with the assets being held in the name of the fund itself.

Risk

Although there are no specific rules on risks for exempted funds, the offering memorandum of such a fund must disclose all material risks to potential investors so as to enable them to make an informed decision on whether or not to invest in the fund.

Valuation and Pricing

AIFs are free to specify the method and frequency of their valuations.

System and Controls

AIFs are not regulated as strictly as retail funds. Given that they can only be offered to sophisticated or high net worth investors, they are spared the application of the various prudential and conduct of business rules that are generally applicable to retail funds.

Insider Dealing and Market Abuse

The Securities Act 2005 contains a chapter on market abuse, which creates the offences of insider dealing, false trading, market rigging, fraud, and deceptive conduct involving securities. The prohibition on insider dealing is a general prohibition applicable to any person who uses insider information to deal in the securities of a reporting issuer (directly or indirectly) or who discloses insider information unlawfully.

Transparency

AIFs have reduced filing and publication requirements. Nonetheless, they are still required to file annual financial statements and to keep the regulator informed of any material change in the AIF.

Money Laundering

All funds must comply with:

- the Financial Intelligence and Anti-Money Laundering Act 2002 (inspired by the Financial Action Task Force principles);
- the Financial Intelligence and Anti-Money Laundering Regulations 2018; and

- the Financial Services Commission Anti-Money Laundering and Countering the Financing of Terrorism Handbook 2020 (issued by the FSC, which is the supervisory authority of funds for money laundering and related purposes).

Funds must carry out customer due diligence (CDD) in accordance with the law, including verifying the identity of investors and being satisfied that the source of funds is lawful. For corporate investors, the fund must obtain copies of incorporation documents to establish the existence of the fund and the identity of its principals. The fund must also provide CDD information on the investor(s), directors and other principals, including beneficiaries, account signatories, and any person operating under a power of attorney.

Reduced or enhanced CDD may be applied, depending on the profile of the investors, whether they are regulated institutions, and their country of domicile. Moreover, funds are required to appoint a money laundering reporting officer, a deputy money laundering reporting officer and a compliance officer who are conversant with the AML laws of Mauritius.

Funds are also required to comply with the United Nations (Financial Prohibitions, Arms Embargo and Travel Ban) Sanctions Act 2019 (the "UN Sanctions Act"), which prohibits dealing with funds or other assets of – or making funds or other assets available to – a party listed on a United Nations Sanctions List or a "designated party" declared as such under the UN Sanctions Act. The UN Sanctions Act also establishes several reporting obligations and authorisation mechanisms, which reporting persons (including funds) must implement.

Short Selling

There are no rules that specifically address short selling.

Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standard (CRS) Regimes

FATCA

The Republic of Mauritius and the government of the USA have signed an Agreement for the Exchange of Information Relating to Taxes (the "Agreement") and the Inter-Governmental Agreement ("Model 1 IGA") to improve international tax compliance and implement the FATCA. The Agreement provides for the exchange of tax information (upon request, spontaneously, and automatically) between Mauritius and the USA, whereas the IGA provides for:

- the automatic reporting and exchange of information in relation to accounts held with Mauritian financial institutions by US persons; and
- the reciprocal exchange of information regarding financial accounts held by Mauritius residents in the USA.

Following the IGA, Mauritius financial institutions will not be subject to the 30% withholding tax on US-sourced income if they comply with the requirements of the FATCA.

CRS

Mauritius has signed the Convention on Mutual Administrative Assistance in Tax Matters (the "Convention") developed by the OECD – under which, information can be exchanged on request, spontaneously or automatically. Thus, Mauritius will be able to exchange information automatically on a reciprocal basis with all jurisdictions that have signed the Convention. Mauritian financial institutions must report annually to the Mauritius Revenue Authority on the financial accounts held by non-residents for eventual exchange with relevant treaty partners.

Funds in Mauritius must assess their FATCA and CRS classification to determine their reporting requirements to the Mauritius Revenue Authority.

2.5 Fund Finance

Funds in Mauritius can access fund finance for subscription financing and/or leverage. There are no regulatory restrictions in relation to borrowings for funds categorised as expert funds or professional CISs; these requirements will be guided by the fund documentation.

Typically, a fund finance transaction related to private equity funds will be secured by security over the fund's bank accounts and the assignment of rights to make capital calls. The latter is accompanied by a power of attorney in favour of the lender to exercise such rights on behalf of the fund/general partner and/or manager (as the case may be), in addition to the assignment.

The main issues are the restrictions on the creation of security rights over capital commitments/calls or the use of investor contributions. These restrictions may be set out in the private equity fund's documentation and more especially the side letters between the fund and a particular investor. It is also common for investors to resist acknowledging any notice of assignment and refuse to pay the lender directly.

2.6 Tax Regime

The tax status of alternative funds established in Mauritius will depend on the type of vehicle used to structure a fund. Funds are generally structured as companies or limited partnerships.

Companies

Companies are tax opaque. Where a fund is structured as a company, it is liable to pay tax on its chargeable income at the rate of 15% and may be subject to a corporate climate responsibility levy of 2% on its chargeable income where its turnover exceeds MUR50 million.

However, a CEF or CIS duly authorised by the FSC may be entitled to benefit from a partial exemption of 80% on all its income (except interest income) and a partial exemption at the rate of 95% on interest income if it satisfies the following conditions relating to the substance of its activities, among other things. The partial exemption of 80% on all income is also available to a CIS manager, CIS administrator, investment adviser, investment dealer or asset manager duly authorised by the FSC.

The substance conditions are that the company:

- carries out its core income-generating activities in Mauritius;
- employs, directly or indirectly, an adequate number of suitably qualified persons to conduct its core income-generating activities; and
- incurs a minimum expenditure proportionate to its level of activities.

Alternatively, a company may be entitled to claim foreign tax paid on its foreign source income as credits against the income tax payable in Mauritius (up to a maximum of 15% or up to 17% where a corporate climate responsibility levy is applicable) in respect of that income, where this can be evidenced ("Foreign Tax Credit"). The Mauritius Income Tax Act 1995 (ITA) defines "foreign source income" as income that is not derived in Mauritius.

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There is no withholding tax on dividends distributed by a company to its shareholders. Furthermore, any interest paid to a non-resident not carrying out any business in Mauritius by a company holding a GBL will be exempt from withholding tax to the extent that the interest is paid out of the fund's foreign source income. There is no tax applicable to capital gains in Mauritius.

Limited Partnerships

A fund structured as a limited partnership will be tax transparent, unless it also holds a GBL – in which case, it can elect to be tax opaque and the tax treatment will be similar to that of a company. Funds structured as limited partnerships that have elected to be tax transparent will not be taxable in Mauritius (but may be subject to a corporate climate responsibility levy of 2%) if they qualify as a resident *société* under the ITA; instead, their partners are liable to income tax on their share of income. A limited partnership will meet the criteria of a resident *société* as understood under the ITA when the seat of the limited partnership is in Mauritius and the limited partnership has at least one partner resident in Mauritius.

Tax-opaque entities are entitled to benefit from the various tax treaties that Mauritius has with other countries.

The above-mentioned tax considerations would be applicable to a fund established as a CIS and to a CEF.

There is no withholding tax on the following payments by a fund established as a company or as a limited partnership:

- distribution by the fund to its resident and non-resident investors;
- in respect of a fund holding a GBL, interest paid to non-residents out of the fund's foreign source income; or
- interest paid to a company resident in Mauritius.

Special Purpose Funds

In line with the ITA, a special purpose fund is a tax-exempt vehicle under Mauritian law. Any interest, rents, royalties, compensation and other amounts paid to a non-resident by a special purpose fund established under the Financial Services Act 2007 will also be exempt from Mauritian income tax.

Non-Resident Investors

An investor who is not tax resident in Mauritius and who does not otherwise derive any income from Mauritius is not required to pay any tax in Mauritius, whether in respect of income or gains (including distributions) received from a fund, its worldwide income or otherwise. Such an investor is not required to make any tax filing in Mauritius.

In respect of limited partnership funds, insofar as the fund derives foreign source income, the partners who are not tax resident in Mauritius will not be subject to tax by reason of being a partner in the fund. Partners who are tax resident in Mauritius will be subject to tax in Mauritius, as set out further in "Resident Investors".

Where a non-resident investor derives Mauritian source income, the investor will be required to file an income tax return in Mauritius.

Resident Investors

An investor who is tax resident in Mauritius will be liable to income tax as follows:

- at the rate of 15% for a body corporate; or

- if the investor is an individual, the chargeable income of the investor will be subject to a progressive tax ranging from 0% to 20%.

Further, a tax-resident investor may be subject to a corporate climate responsibility levy of 2% on its chargeable income in respect of each year of assessment (first year commencing on 1 July 2024) where their turnover for that year of assessment exceeds MUR50 million.

A tax-resident investor that is a body corporate will be entitled to benefit from the Foreign Tax Credit or as a partial exemption of 80% in respect of the following types of income:

- foreign source dividend, provided that such dividend is not allowed as a tax-deductible item in the source country and the company satisfies the conditions relating to the substance of its activities as prescribed;
- interest derived by a company (other than a bank referred to in Section 44C of the ITA, a non-bank deposit-taking institution, a money changer, a foreign exchange dealer, an insurance company, a leasing company, or a company providing factoring, hire purchase facilities or credit sales facilities) – provided that the company satisfies the conditions relating to the substance of its activities as prescribed;
- profit attributable to a permanent establishment held by a resident company in a foreign country;
- income derived by a CIS, CEF, CIS manager, CIS administrator, investment adviser or asset manager licensed or approved by the FSC;
- income derived by companies engaged in ship and aircraft leasing;
- income derived by a company from reinsurance and reinsurance brokering activities, subject to satisfying any conditions prescribed relating to the substance of its activities;
- income derived by a company from the leasing and provision of international fibre capacity, subject to satisfying any conditions prescribed relating to the substance of its activities;
- interest derived by a person from money lent through a peer-to-peer lending platform; and
- income derived by a company from the sale, financing arrangement, and asset management of an aircraft and its spare parts (and the provision of aviation advisory services related thereto), subject to satisfying any prescribed conditions relating to the substance of its activities.

A tax-resident investor who is an individual will be entitled to:

- Foreign Tax Credit;
- deduct the applicable amount of personal reliefs and deductions from their net income in each income year; and
- any other reliefs, allowances and deductions as apply.

Any dividend income received or gains made by any Mauritian investor from a fund established as a company in Mauritius are exempt from income tax.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Retail funds can be set up as companies, limited partnerships, PCCs, trusts or VCCs, as described in **2.1.1 Fund Structures**.

3.1.2 Common Process for Setting Up Investment Funds

A fund in Mauritius is regulated as a CIS or a CEF and a fund authorisation is required from the FSC. A retail fund conducting business principally outside of Mauritius, the majority of whose shares/voting rights/legal or beneficial interests are held by non-citizens, will also be required to apply for a GBL.

The process for setting up retail funds would entail making a similar name reservation and formal application to the authorities as described in **2.1.2 Common Process for Setting Up Investment Funds** and the same timeframe and fees would apply.

3.1.3 Limited Liability

The liability of investors participating in structures such as companies limited by shares or limited partnerships will be limited to the amount they have contractually undertaken to pay to the fund, so long as their participation remains passive, as detailed in **2.1.3 Limited Liability**.

3.1.4 Disclosure Requirements

A fund authorised in Mauritius needs to file an offering document with the FSC. The type of offering document and the relevant disclosure in this document will vary depending on the category of the fund and the target investors. The offering document should contain all the necessary information on the securities to be offered and the fund to enable investors to make an informed assessment of the investment.

A prospectus is required for funds targeting the public or retail investors and needs to comply with the prescribed disclosure requirements, including the matters required by the Mauritius Securities Act 2005 and the rules and regulations made thereunder, such as:

- investment objectives and restrictions;
- the details and functions of the investment manager;
- events concerning the termination of a manager's appointment;
- the types of investors targeted and the recommended lock-in periods;
- the terms of subscription (including minimum initial or subsequent investment, distribution rights, entry or exit fees, method/procedure of subscription or redemption, and method and frequency of NAV calculations); and
- any fees or charges to be attributed to the fund.

Reporting Requirements

Collective investment schemes (retail funds)

An open-ended retail fund must file audited financial statements and an annual management report with the regulator, containing matters prescribed by the fund regulations. The audited financial statements should be made public unless the fund holds a GBL.

Closed-end funds (retail funds)

A closed-end retail fund must file with the regulator and make public the following:

- comparative quarterly financial statements prepared in accordance with the International Financial Reporting Standards (IFRS), no later than 45 days after the end of each quarter; and
- an annual report, including audited comparative financial statements prepared in accordance with the IFRS and audited as per International Standards on Auditing (or such other permitted standards), no later than 90 days after the fund's balance sheet date.

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The quarterly reports and annual reports of closed-end retail funds (other than those funds that hold a GBL) must also be made public.

In the case of a public offering, the retail fund must register itself as a reporting issuer and is subject to an additional disclosure requirement (to the FSC). Reporting issuers must notify the FSC of any material changes to their affairs.

REITs

A REIT must file with the regulator and distribute to participants the following:

- a half-yearly report (including financial statements prepared in accordance with the IFRS), no later than 45 days from its interim period; and
- an annual report, including audited comparative financial statements prepared in accordance with the IFRS and audited in accordance with the International Standards on Auditing (or such other permitted standards), no later than six months from its balance sheet date.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

There is a diverse range of investors for retail funds – from individuals and corporates to institutional investors, development finance institutions, family offices and financial institutions.

3.2.2 Legal Structures Used by Fund Managers

Fund managers are typically set up as companies incorporated under the Companies Act 2001. Please see **2.2.2 Legal Structures Used by Fund Managers**.

3.2.3 Restrictions on Investors

CISs and CEFs that are retail funds have no limitation on the type of investor or minimum investment by investors. However, the prospectus can set out specific eligibility criteria for investors or any minimum investment.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

There are two main categories of funds: CISs and CEFs.

A CIS has a number of restrictions on its investment and practices, which may be lifted with the approval of the FSC if it is satisfied that the fund has justification, and provided that the fund makes adequate disclosure in its prospectus as to investment rules and risks. For instance, without the FSC's approval, a CIS cannot:

- invest more than 5% of its net assets in the security of the issuer, unless it is a debt security issued by the government of Mauritius or the government of any other country;
- purchase and hold more than 10% of a class of securities of that issuer;
- purchase real estate;
- purchase a mortgage;
- purchase a security for the purpose of exercising control or management over the issuer of that security;
- have more than 10% of its net assets in illiquid assets;
- purchase or sell derivatives or physical commodities, except within limits established by the FSC;
- subscribe to securities offered by a company in formation;
- lend money, securities or other assets;
- invest in aggregate more than 10% of its NAV in shares of another CIS;

- acquire more than 10% of the shares of any single CIS; nor
- purchase a security nor sell a security to the investment manager, the custodian, an officer of the investment manager or the custodian or any affiliate of such persons, unless the purchase or sale is carried out at arm's length.

It should also be noted that a CIS can only borrow money or create a charge over its assets when:

- the transaction is only a temporary measure to accommodate a request for the redemption of securities of that fund, and the outstanding amount of all borrowings does not exceed 5% of the fund; or
- the charge secures a claim for fees and expenses incurred for services rendered while redeeming those securities.

The investment and borrowing restrictions do not apply to CEFs.

Through its guidelines, the FSC has announced that investments in digital assets and cryptocurrency may not be suitable for retail investors, owing to the high-risk nature of such asset class. However, digital assets including cryptocurrency may constitute an asset class for investment by funds that are authorised as expert funds, professional CISs or specialised CISs.

The FSC has issued the Securities (Real Estate Investment Trusts) Rules 2021, which provide a specific regime for licensing and regulating REITs. A REIT is a CIS or CEF that invests primarily in real estate assets with the aim of providing returns to holders derived from the rental income of the real estate asset.

3.3.2 Requirements for Non-Local Service Providers

The position is the same as that described in **2.3.2 Requirements for Non-Local Service Providers**.

3.3.3 Local Regulatory Requirements for Non-Local Managers

The position is the same as described in **2.3.3 Local Regulatory Requirements for Non-Local Managers**.

Where a retail fund holds a GBL, it will be able to appoint a foreign manager subject to the prior approval of the FSC. The FSC will consider whether the licence of the foreign investment manager is issued by a regulatory body in a jurisdiction that has comparable regulation to Mauritius for investor protection.

3.3.4 Regulatory Approval Process

The timeframe for the application of a fund authorisation is generally around 60 business days from the time the application is submitted to the authorities, assuming the application is complete and related queries are cleared on time. However, the application for a retail fund may be lengthier.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Please see **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**.

In addition, for a retail CEF, unless the prospectus has been approved by the FSC, no application form should accompany the prospectus, no offer for subscription should be entertained, and only indications of interest without a firm commitment may be entertained.

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3.3.6 Rules Concerning Marketing of Retail Funds

The production and offering of marketing materials are governed by the Securities Act 2005, the rules and regulations made under it and the Guidelines for Advertising and Marketing of Financial Products 2014, as detailed in **2.3.6 Rules Concerning Marketing of Alternative Funds**.

In addition, a retail CIS cannot issue, use, or cause to be issued or used – for any purpose – any advertisement in connection with a CIS, unless a copy is forwarded to the FSC no later than five working days prior to the issue or use.

3.3.7 Marketing of Retail Funds

Once authorised, there are no restrictions on the categories of persons to whom retail funds can be marketed, which will follow any eligibility criteria set out in the fund's offer document.

3.3.8 Marketing Authorisation/Notification Process

A retail CIS cannot issue, use, or cause to be issued or used – for any purpose – any advertisement in connection with the CIS, unless a copy of the advertisement is forwarded to the FSC no later than five working days prior to the issue or use. All marketing materials must be submitted to the FSC prior to dissemination.

3.3.9 Post-Marketing Ongoing Requirements

Where any significant change occurs or any new information arises that should be stated in the offer document of a CIS after it has been filed with the FSC, the offer document may be amended by inserting an addendum and notifying the FSC by filing a copy of the addendum therewith. Investors should also be informed of the significant change.

3.3.10 Investor Protection Rules

Given that retail funds target the public, extensive disclosure is required in the prospectus of such funds in order for potential investors to understand the investment and risks. Retail funds need to comply with a list of prescribed disclosure requirements, including the matters required by the Mauritius Securities Act 2005 and the rules and regulations made thereunder, such as:

- investment objectives and restrictions;
- the details and functions of the investment manager;
- events concerning the termination of a manager's appointment;
- the types of investors targeted and the recommended lock-in periods,
- the terms of subscription;
- an explanation of the nature of the risks; and
- any fees or charges to be attributed to the fund.

In addition, the prospectus should specify the type of investors for whom investment in the fund is suitable.

The fund manager must also send an account statement to each investor with full information regarding investment, so as to ensure the investor is fully aware of the overall investment.

3.3.11 Approach of the Regulator

The approach of the regulator is as provided in **2.3.11 Approach of the Regulator**.

3.4 Operational Requirements

Retail funds have investment and borrowing restrictions, as described in **3.3.1 Regulatory Regime**.

A retail fund formed as a CIS must appoint a custodian that holds a custodian licence under the Securities Act 2005 to hold and safekeep the assets of the fund. Only banks and trust companies that are subsidiaries of banks are eligible for a custodian licence. If the fund holds a GBL, it may appoint a foreign custodian with the approval of the FSC. The appointed custodian must act independently from the fund manager and the fund.

CEFs are exempt from the requirement to appoint a custodian, with the assets being held in the name of the fund itself.

Risk

The prospectus of the retail fund must disclose all material risks to potential investors. For retail CISs in particular, the prospectus must explain the nature of the risks, including minimum exposure to stock market, sensitivity to rate of interest risk, exposure to currency risk, concentration risk, derivative risk, foreign investment risk, and investment in illiquid securities risk.

Valuation and Pricing

An open-ended retail fund must conduct a valuation on a daily basis or at such other intervals as agreed with the FSC. The prospectus must describe the valuation method that such fund will employ in valuing its portfolio to arrive at a NAV.

System and Controls

Various prudential and conduct of business rules apply to an open-ended retail fund, such as:

- minimum funding requirements;
- regulation of its constitutive documents and prospectus;
- regulation of its book-keeping principles;
- regulation of transactions with related parties; and
- mandatory investors' voting powers.

Insider Dealing and Market Abuse

The Securities Act 2005 makes a provision for market abuse, which creates the offences of insider dealing, false trading, market rigging, fraud, and deceptive conduct involving securities. The prohibition on insider dealing is a general prohibition applicable to any person who uses insider information to deal in the securities of a reporting issuer (directly or indirectly) or who discloses insider information unlawfully.

Transparency

Retail funds have several disclosure and reporting requirements, as detailed in **3.1.4 Disclosure Requirements**. In addition, an open-ended retail fund must publish the issue, sale, repurchase and redemption prices at least once a week or at such frequency as the FSC may approve.

Money Laundering

There is no difference in the obligations of AIFs and retail funds under the AML laws, as detailed in **2.4 Operational Requirements**.

Short Selling

There are no rules that specifically address short selling. For retail funds, securities lent and collateral received by the fund must be disclosed in the financial statements.

FATCA and CRS Regimes

Funds in Mauritius must assess their FATCA and CRS classification to determine their reporting requirements to the Mauritius Revenue Authority. Please see **2.4 Operational Requirements** for further details.

3.5 Fund Finance

Funds in Mauritius can access fund finance for subscription financing and/or leverage.

A retail fund formed as a CIS can only borrow money or create a charge over its assets when:

- the transaction is only a temporary measure to accommodate a request for the redemption of securities of that fund, and the outstanding amount of all borrowings does not exceed 5% of the fund; or
- the charge secures a claim for fees and expenses incurred for services rendered while redeeming those securities.

CEFs are not subject to any borrowing restriction. Retail CEFs would follow the usual lending practices and take into account the assets and receivables of the fund. There can be issues in financing CEFs where the fund documents set out limitations on the creation of security over assets of the fund.

3.6 Tax Regime

The tax regime that applies to AIFs also applies to retail funds in the manner described in **2.6 Tax Regime**. An investor in a retail fund is taxed in the same manner as an investor in an AIF, as described in **2.6 Tax Regime**, and there is no special or preferential tax regime for investors participating in retail funds.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Introduction of Corporate Climate Responsibility Levy

Starting from 1 July 2024, every company (as defined in the Income Tax Act and which includes a *société*) is liable to pay a corporate climate responsibility levy of 2% on its chargeable income in respect of each year of assessment where the turnover of the company for that year of assessment exceeds MUR50 million.

Entities such as companies, PCCs, VCCs, resident *sociétés* (including limited partnerships), foundations and trusts that are tax resident in Mauritius and derive chargeable income from any source and entities that are not tax resident but derive chargeable income from a Mauritian source, shall be subject to the corporate climate responsibility levy if they meet the minimum turnover criteria. This includes entities holding a GBL that derive chargeable income from any sources.

New Post-Licensing Fees

Effective as of 1 August 2024, new post-licensing fees to be paid to the FSC will be applicable in relation to certain matters. These matters include but are not limited to applying for duplicate licences, as well as processing a change of name, a change in management company, and a change in registered agent.

Applications for FSC Licences

The Financial Services Act 2007 was amended to include a new section that provides that applications for licences will be expedited and must be granted within ten working days from the date the application is determined to be complete by the FSC.

The FSC issued the Financial Services (Determination of Application) Rules 2024 in September 2024. The purpose of these guidelines is to provide guidance on how the FSC determines the completeness of an application for a licence (including authorisation, registration or approval), what constitutes a complete application, and the process for granting an application.

NETHERLANDS

Amsterdam
Netherlands
Germany
Belgium

Law and Practice

Contributed by:
Vilmar Feenstra, Robert Veenhoven, Joyce Kerkvliet and Sebastiaan Verkerk
Loyens & Loeff N.V.

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Loyens & Loeff N.V. has over 70 dedicated specialists in its investment management practice group that are based in Amsterdam, with a similar number of professionals based in Luxembourg. This makes the investment management practice one of the firm's core practices. Loyens & Loeff offers clients a unique combination of tax, legal and regulatory advice on the structuring of funds and all other investment management work, and is very skilled in combining the various detailed tax and regulatory regimes and rules in cross-border structures. An integrated approach is vital for the firm's investment management practice and makes Loyens & Loeff stand out in the market. The firm has a strong international capability in relevant jurisdictions. The Netherlands, Luxembourg, Belgium and Switzerland are its four home markets, and it has offices in New York and London with an investment management focus. The Amsterdam-based team assists the majority of the Dutch-based fund managers with their fundraisings and general legal maintenance of their funds.

Authors

Vilmar Feenstra is an Amsterdam-based attorney at law and a partner in the investment management practice group at Loyens & Loeff. Vilmar focuses on investment management structures and fund formation and is active both on the GP and LP side. He has assisted managers with the formation of their funds and acted on behalf of institutional investors in respect of their investments in various funds. He worked in the New York office from 2013 to 2014, during which time he provided corporate and transactional advice to various companies.

Robert Veenhoven is an Amsterdam-based tax partner in the investment management practice group at Loyens & Loeff. He advises fund managers active in the fields of, among others, private equity, venture capital, renewable energy and infrastructure on the international tax aspects of fund formation, management participation and deal structuring. Robert publishes and speaks on a variety of topics, including tax aspects of investment funds and financing transactions. In 2021, Robert was the co-author of a handbook on Dutch legal aspects of investment institutions. Previously, he was seconded to the London office to work on a variety of international transactions.

Joyce Kerkvliet is an Amsterdam-based attorney at law and a counsel in the investment management practice group at Loyens & Loeff. She frequently advises on topics such as AIFMD, UCITS, MiFID II, the SFDR/Taxonomy Regulation, MAR, and the Fourth and Fifth AML Directives. Joyce has extensive experience with assisting asset managers with various applications and notifications and assists them with navigating ongoing regulatory and compliance issues related to the investment management industry. Her prior experience of having worked at the Netherlands Authority for the Financial Markets (AFM) is particularly helpful for clients.

Sebastiaan Verkerk is a senior attorney at law and a member of the investment management practice group based in Loyens & Loeff's Amsterdam office. Sebastiaan's practice focuses on the formation and operation of private investment funds across a variety of investment strategies, including related aspects of the alternative investment class such as co-investment arrangements, continuation funds, spin-outs and employee incentive schemes. Sebastiaan was seconded to Loyens & Loeff's London office.

Loyens & Loeff N.V.

Parnassusweg 300
1081 LC Amsterdam
Netherlands

Tel: +31 205 785 2 03
Fax: +31 612 375 052
Email: Vilmar.feenstra@loyensloeff.com
Web: www.loyensloeff.com

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Law & Tax

NETHERLANDS LAW AND PRACTICE

Contributed by: Vilmar Feenstra, Robert Veenhoven, Joyce Kerkvliet and Sebastiaan Verkerk, **Loyens & Loeff N.V.**

1. Market Overview

1.1 State of the Market

The Netherlands is a jurisdiction commonly used for the formation of investment funds, and has a sophisticated, clear and flexible legal and governance system. In addition to its stable business and political environment, the Netherlands has various tax advantages that also make it an attractive fund jurisdiction. Capital is raised both internationally and from domestic investors (eg, Dutch pension funds).

As a location for private equity and venture capital funds, the Netherlands is typically used by fund managers who operate in and from the Netherlands. However, the Netherlands is also frequently used as a fund structuring and platform jurisdiction by fund managers who have their head offices outside the Netherlands, in which case they typically have some form of presence in the Netherlands, often for operational purposes.

Despite a slowdown in deal volume, the Dutch fundraising market continues to demonstrate resilience and growth. Although there is a trend of fundraisings taking longer, Dutch fund managers are still able to secure substantial funds from a diverse range of investors, including, but not limited to, Dutch pension funds, insurance companies, family offices, high-net-worth individuals and regional public investment institutions. Investing in private equity funds is becoming more common among individuals, with a trend known as the “retailisation” of private markets. This comprises offering people the chance to invest through so-called “feeder” vehicles.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

In the Netherlands, depending on the tax analyses performed in relation to them, alternative investment funds (AIFs) are generally structured in the form of a limited partnership (*commanditaire vennootschap*, or CV), a co-operative (*coöperatie*, or Coop), a contractual fund for joint account (*fonds voor gemene rekening*, or FGR) and/or a private limited liability company (*besloten vennootschap met beperkte aansprakelijkheid*, or BV), or a combination thereof.

Private Equity Funds

Private equity funds are generally structured in the form of a CV or a Coop.

CV

A CV is a limited partnership for the purpose of a durable co-operation between one or more managing (or general) partners (*beherend vennoten*), each with unlimited liability, and one or more limited partners (*commanditaire vennoten*), with limited liability (see **2.1.3 Limited Liability**). A CV has no legal personality and is not a separate legal entity distinct from its partners. In principle, assets cannot be held by a CV in its own name, but are held by a community of property of the partners (*gemeenschap*) or by one or more partners or a third party for the account of the community of property of the partners. Investors participate in the CV as limited partners and receive a limited partnership interest in the AIF. Substantially all terms and conditions of an AIF can be laid down in the limited partnership agreement of the CV.

A proposed legislative reform may impose substantial changes to Dutch partnership laws (see

4.1 Recent Developments and Proposals for Reform).

Coop

A Coop is a special form of association and is a separate entity from its members (ie, it has separate legal personality), with legal title and beneficial ownership of its assets. Investors participate in a Coop as members, with corresponding membership interests. The terms and conditions of the investment fund are typically laid down in a membership agreement (in addition to the articles of association of the Coop). A Coop does not have capital divided into shares or units. Units can be created to accommodate the tax requirements of certain investors.

BV

A BV is the Dutch equivalent of a private company with limited liability, and is generally the preferred legal form for privately held companies in the Netherlands. The BV is a legal entity with capital divided into one or more transferable shares, and has legal personality. A BV is incorporated by the execution of a notarial deed of incorporation (including the articles of association of the BV) to that effect.

Hedge Funds, Debt Funds and Real Estate Funds

These types of funds are generally structured in the form of an FGR, which is not a legal entity. It is generally a contractual arrangement sui generis (often referred to as its terms and conditions) between a fund manager and each investor (ie, each participant) separately, obliging the fund manager to invest and manage assets contributed by the participants for their joint account. Generally, the legal ownership of the FGR assets is held by a separate legal entity (ie, the title-holder). The FGR is not dealt with in Dutch corporate law. Parties are free to determine the financial and governance structure of an FGR.

The FGR is established by the execution of a notarial or private deed setting out its terms and conditions. The parties involved are the fund manager, the title-holder and each of the participants separately. The UBOs of an FGR need to be registered in the trust register, which, after a European Court of Justice ruling, is no longer publicly available.

2.1.2 Common Process for Setting Up Investment Funds

Although the process for setting up an investment fund in the Netherlands shall mainly depend on the specific facts and circumstances, as a general rule, fund managers typically start discussing the structure and terms and conditions of the investment fund with their professional advisers. The fund manager will decide on the fund structure (primarily based on the attributes of the prospective investors, the fund's investment strategy and related tax considerations) and will prepare a term sheet setting forth the main terms and conditions of the investment fund.

In order to start (pre-)marketing activities, the fund manager will prepare the marketing material. Depending on the regulatory regime of the investment fund (see below), (regulatory) approvals and/or registrations will first need to be obtained and/or made before the fund manager may approach potential investors. The fund manager typically makes available the fund agreement, management agreement (if applicable) and subscription agreement. Additional investors may be admitted at subsequent closings. During negotiations, investors may request side letters and/or legal and tax opinions.

Under Dutch law, the regulatory regime and supervision with respect to externally managed AIFs concern the alternative investment fund manager (AIFM) of an AIF, rather than the AIF itself (unless the latter is managed internally). The regulatory regimes that apply to Dutch AIFMs and non-Dutch AIFMs when setting up Dutch AIFs are discussed below.

Dutch AIFM

The fully licensed regime

Pursuant to the Dutch Act on Financial Supervision (*Wet op het financieel toezicht*, or AFS), an AIFM is prohibited from managing an AIF or marketing interests in an AIF in the Netherlands without a licence thereto from the Netherlands Authority for the Financial Markets (*Stichting Autoriteit Financiële Markten*, or AFM), unless an exemption or exception applies.

The AFM will grant a licence to a Dutch AIFM upon application if the AIFM meets the requirements under Dutch law implementing the Alternative Investment Fund Managers Directive (2011/61/EC, or AIFMD). The licence requirements relate to, inter alia, the suitability and trustworthiness of the board members, the operational and control structure of the AIFM, the management of potential conflicts of interest, the appointment of a depositary, and solvency and capital requirements. The AFM has a review period of up to 26 weeks and may request additional documents or information during the application process (the review period will then be suspended). In practice, therefore, the process to obtain a licence takes more time.

If a Dutch AIFM holds a licence from the AFM pursuant to the AIFMD, it is, in principle, allowed to manage AIFs and to offer the interests in the AIF it manages to professional investors (within the meaning of the AFS) in the Netherlands. If the AIFM complies with the “retail top-up regime” (as discussed in **3. Retail Funds**), the AIFM may also offer interests to non-professional investors in the Netherlands.

A licensed Dutch AIFM can only manage a new AIF within the investment strategy covered by its licence and can market such AIF to professional investors if it has obtained approval thereto from the AFM. To obtain such approval, a so-called investment institution notification form should be submitted to the AFM through its digital portal, with, inter alia, the following attached:

- a structure chart of the AIF and all connected entities;
- the fund agreement and other contractual arrangements between the vehicle and the investors;
- the prospectus in which the information required pursuant to Article 23 of the AIFMD is contained; and
- a notification form containing information on the depositary.

The AFM has one month to decide on the application, which can be extended by one month. If the AIF is managed or marketed to professional investors outside the Netherlands, a marketing passport needs to be obtained, pursuant to the Dutch implementation of Article 32 of the AIFMD.

A Dutch-licensed AIFM can also pre-market an AIF in the Netherlands or another EU member state to professional investors, provided it made a pre-marketing notification to the AFM and the conditions set forth in Article 30a of the AIFMD, as implemented in the Netherlands, are met.

Registration regime for “small managers”

There is an exception from the above-mentioned licence obligation for Dutch AIFMs that can make use of the small managers registration regime (the "small managers regime") of Section 2:66a of the AFS. To be able to make use of this exemption, each of the following conditions has to be met by the AIFM.

- The AIFM manages directly – or through an undertaking with which it is linked through common management, common control or a qualified holding – portfolios of AIFs whose assets under management (AuM) in total do not exceed (the "AuM Thresholds"):
  (a) EUR100 million; or
  (b) EUR500 million if all the AIFs managed by the AIFM are unleveraged and there are no redemption or repayment rights exercisable with respect to interests in the AIFs for a period of five years following the date of the acquisition of the interests in the respective AIFs.
- Interests in each AIF managed by the AIFM may only be marketed (the "Placement Restrictions"):
  (a) to professional investors within the meaning of Section 1:1 of the AFS;
  (b) to fewer than 150 persons; or
  (c) for a countervalue of at least EUR100,000 per investor.

The AFM clarified that the following conditions should be met, in order to make use of the third Placement Restriction mentioned above:

- the amount of the first capital commitment per investor is at least EUR100,000 (exclusive of costs);
- the first amount called under the commitment per investor should be at least EUR100,000; and
- the amount of committed capital may never fall below EUR100,000.

A Dutch AIFM that meets the AuM Thresholds and the Placement Restrictions and wants to make use of the small managers regime needs to register itself and the AIF it manages/intends to market with the AFM, by submitting a registration form through the AFM's digital portal (including an overview of the AuM and a description of the investment strategy). The AFM charges EUR4,400 for a registration. After review and acceptance of the registration form, the AIFM and the AIFs managed by it will be included in the public register of the AFM kept on its website. If the AIFM meets the conditions of the small managers regime, it can start managing the AIF and marketing the AIF in the Netherlands after the registration is submitted to the AFM. There is no waiting period.

If the AIFM wishes to raise a new AIF after registering itself, it should register the AIF two weeks prior to the commencement of the marketing of the AIF. This term of two weeks is a request from the AFM and is not provided for in Dutch legislation, but it is advisable to take this period into account. If the AIFM exceeds the AuM Thresholds or no longer fulfils the Placement Restrictions, the AIFM must apply for a licence from the AFM within 30 calendar days thereafter.

Non-Dutch AIFM

A non-Dutch AIFM that intends to set up a Dutch AIF should comply with the following regulatory regimes, depending on whether the non-Dutch AIFM is an EU AIFM or a non-EU AIFM.

EU Non-Dutch AIFM

An EU AIFM with an AIFMD licence in another EU member state can manage a Dutch AIF pursuant to a passport obtained in accordance with Article 33 of the AIFMD in its home member state.

An EU sub-threshold AIFM is, pursuant to a recent change in Dutch law, allowed to manage a Dutch AIF provided it complies with the conditions as set forth in the Registration regime for "small managers" as set out above and interests in the AIF are only marketed to professional investors.

Non-EU AIFM

A non-EU AIFM that intends to manage a Dutch AIF needs to comply with the Dutch implementation of the national private placement regime of Article 42 of the AIFMD (NPPR). A number of conditions apply in order to make use of the Dutch NPPR, such as:

- that interests in the AIF can only be marketed to professional investors;
- a memorandum of understanding is entered into between the competent supervisory authority of the non-EU AIFM and the AFM, and the third country in which the non-EU AIFM and/or non-EU AIF is established should not be listed as a non-cooperative country for the purposes of the Financial Action Task Force (FATF);
- the AFM is notified by the non-EU AIFM through a notification form including an attestation of the competent supervisory authority of the non-EU AIFM; and
- certain transparency rules of the AIFMD are complied with, as set out in Articles 22, 23, 24 and 26–30 of the AIFMD.

A non-EU AIFM can also pre-market an AIF in the Netherlands to professional investors, provided it made a notification to the AFM and the conditions set forth in Article 30a of the AIFMD, as implemented in the Netherlands, are met.

2.1.3 Limited Liability

The Dutch legal forms commonly used for investment fund formations are a CV, a Coop, an FGR and/or a BV. All these forms provide for the limited liability of investors. Typically, upon the request of investors, legal opinions are given in this respect, subject to the customary assumptions and qualifications.

The Netherlands, furthermore, provides for two specific tax fund regimes that may be used for specific strategies:

- the exempted investment institution (*vrijgestelde beleggingsinstelling*, or VBI); and
- the fiscal investment institution (*fiscale beleggingsinstelling*, or FBI) – note, however, that for direct real estate investments this regime is expected to be abolished in 2025.

CV

A CV is a limited partnership for the purpose of a durable co-operation between one or more managing (or general) partners, each with unlimited liability, and one or more limited partners (*commanditaire* or *stille vennoten*) who are not liable towards third parties for the obligations of the CV in excess of the amount they have contributed or have agreed to contribute to the CV, unless the names of the limited partners (or characteristic elements of their names) are used in the name of the CV, or the limited partners engage in any act of management or control (*daden van beheer*) or are involved in any activities of the CV (even by virtue of a power of attorney – *volmacht*). However, a limited partner may be held liable for obligations of the CV if:

- such limited partner has committed a tort (*onrechtmatige daad*);
- such limited partner qualifies as a policymaker (*beleidsbepaler*) or a co-policymaker

(*medebeleidsbepaler*) of the general partner and there is evidently improper management of the general partner;
- such limited partner voluntarily assumes liability for the obligations of the CV; or
- in certain exceptional circumstances only, a limited partner is identified with a general partner.

A proposed legislative reform may impose substantial changes to Dutch partnership laws (see **4.1 Recent Developments and Proposals for Reform**).

Coop

If the articles of association of the Coop do not provide otherwise, members and former members of a Coop are liable for deficits upon liquidation or bankruptcy. However, Dutch law allows the liability of the members to be limited or excluded in the articles of association. The letters WA (*wettelijke aansprakelijkheid* – unlimited liability), BA (*beperkte aansprakelijkheid* – limited liability) or UA (*uitsluiting van aansprakelijkheid* – exclusion of liability), respectively, have to be added to the name of the Coop to indicate the level of liability of the members. A member of a Coop UA is not liable for any deficit of the Coop. However, a member of a Coop UA may still be held liable for the obligations of the Coop if:

- such member has committed a tort;
- such member qualifies as a policymaker or a co-policymaker of the Coop and there is evidently improper management of the Coop; or
- such member voluntarily assumes liability for the obligations of the Coop.

BV

A BV is a legal entity with capital divided into one or more transferable shares, which has legal personality (*rechtspersoonlijkheid*). A shareholder of a BV is, in principle, not liable for acts performed in the name of the company, and does not have to contribute to the losses of the company in excess of the amount to be paid up on its shares. However, the liability of a shareholder for the obligations of the BV may arise if:

- such shareholder committed a tort;
- such shareholder qualifies as a policymaker or a co-policymaker of the company and there is evidently improper management of the company;
- such shareholder voluntarily assumes liability for the obligations of the company;
- in exceptional circumstances, where “hiding” behind separate legal identities constitutes an abuse of law, such shareholder may be identified (*vereenzelvigd*) with the company; or
- a shareholder receives a distribution in excess of the company’s freely distributable reserves while being aware – or when it reasonably should have been aware – that such distribution was not permitted.

FGR

The liability of a participant of an FGR to make contributions is generally limited to the amount that such participant has agreed to pay. However, although the FGR is not a legal entity (*rechtspersoon*) or a partnership (*personenvennootschap*), but a contractual arrangement sui generis, the possibility of an FGR being requalified as a partnership (*maatschap/vennootschap onder firma*) or a limited partnership among the fund manager, the title-holder and the investors (ie, the participants) or among the participants cannot be ruled out if, as a factual matter, it meets the constitutive requirements of such a partnership. Upon such a requalification, the investors may become liable for equal amounts (*gelijke delen*) – if the FGR is requalified as a *maatschap* – or jointly and severally liable (*hoofdelijk aansprake-*

lijk) – if the FGR is requalified as a *vennootschap onder firma* or *commanditaire vennootschap* – for the liabilities of such partnership.

2.1.4 Disclosure Requirements

Dutch AIFMs

Pursuant to the Dutch implementation of Article 23 of the AIFMD, a Dutch-licensed AIFM should provide professional investors with a prospectus setting out the disclosures required pursuant to Article 23 of the AIFMD when marketing an AIF in the Netherlands. If the AIF is marketed under the retail top-up regime to non-professional investors that invest less than EUR100,000, additional disclosure requirements apply, as set out under **3. Retail Funds**. Also, if the AIF is marketed to non-professional investors, a Key Information Document (*Essentiële-informatiedocument*, or KID) must be made available to non-professional investors pursuant to Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), regardless of the amount invested.

Dutch AIFMs that are registered under the small managers regime should include a selling legend in the private placement memorandum and other marketing materials, in which the Placement Restrictions that will be used by the AIFM (as set out in **2.1.2 Common Process for Setting Up Investment Funds**) are explained. If the marketing is not limited to professional investors, the marketing materials and offering documentation must contain an exemption statement in an AFM prescribed format, and a KID has to be prepared and made available to the non-professional investors. In addition, if an AIF is closed-ended with tradable units, the AIF should publish an approved prospectus pursuant to the Prospectus Regulation (EU 2017/1129), unless an exemption applies.

Furthermore, pursuant to the SFDR and Taxonomy Regulation (Regulation (EU) 2020/852, the “Taxonomy Regulation”), Dutch AIFMs are required to make certain disclosures both at the legal entity and at the financial product level in, among others, the prospectus or private placement memorandum and on the website of the AIFM.

Non-Dutch AIFMs

With respect to EU AIFMs, on the basis of their home country rules implementing the AIFMD, authorised AIFMs from other European Economic Area (EEA) member states will be required to provide a prospectus when marketing to Dutch investors, pursuant to Article 32 of the AIFMD. If the AIF is marketed under the Dutch retail top-up regime to non-professional investors that invest less than EUR100,000, additional disclosure requirements apply, as set out under **3. Retail Funds**. Also, if the AIF is marketed to non-professional investors, a KID should be provided pursuant to Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), regardless of the amount invested. In addition, if an AIF is closed-ended with tradable units, the AIF should publish an approved prospectus pursuant to the Prospectus Regulation (EU 2017/1129), unless an exemption applies.

With respect to non-EU AIFMs, the non-EU AIFM that is marketing an AIF pursuant to the Dutch NPPR should provide a prospectus setting out the disclosures required pursuant to Article 23 of the AIFMD when marketing an AIF in the Netherlands to professional investors. In addition, the disclosure requirements pursuant to the SFDR and Taxonomy Regulation for Dutch AIFMs apply mutatis mutandis to non-EU AIFMs.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

The main fund investors located in the Netherlands investing in investment funds are Dutch pension funds, commercial banks and insurance companies. There are also multiple Dutch family offices and multi-family offices/asset managers, high-net-worth individuals and regional public investment institutions that invest in investment funds. The Dutch government (via the European Investment Fund, or EIF) frequently invests in Dutch funds targeting SMEs.

2.2.2 Legal Structures Used by Fund Managers

Dutch fund managers often adopt the legal form of a BV to carry on their risk and portfolio management activities for the benefit of the investment funds under management.

2.2.3 Restrictions on Investors

AIFMs under the small managers regime may only offer the interests in each AIF in accordance with the Placement Restrictions.

Dutch or EU-licensed AIFMs may only offer the interests in the AIFs they manage to professional investors (within the meaning of Section 1:1 of the AFS), unless they have opted for the "retail top-up". The AIFM is not required to comply with the requirements under the retail top-up regime if interests are offered for a countervalue of more than EUR100,000 per investor.

Non-EEA AIFMs making use of the Dutch NPPR may only offer interests to "qualified investors" within the meaning of the AFS.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Under Dutch law, the regulatory regime and supervision with respect to investment funds is the concern of the fund manager of an investment fund, rather than the investment fund itself (unless the latter is managed internally). In principle, fund managers of AIFs that are active in the Netherlands fall within the scope of the AIFMD and the Dutch implementation thereof in the AFS, and the rules and regulation promulgated thereunder.

It is, in principle, prohibited in the Netherlands for an AIFM to manage an AIF or to market interests in an AIF without having obtained a licence from the AFM. This is only different if an exemption to the licence requirement is available, such as using a passport by a licensed EU AIFM, making use of the small managers regime or registration under the NPPR. In principle, there are no investment limitations, other than those included in the authorisation (licence or registration).

2.3.2 Requirements for Non-Local Service Providers

Pursuant to the Dutch Trust Offices Act 2018 (*Wet toezicht trustkantoren*2018), it is prohibited to provide the following trust services (*trustdiensten*) in the Netherlands, unless a licence to do so has been obtained from the Dutch Central Bank (*De Nederlandsche Bank NV*, or DNB):

- being a director/partner of a legal entity/company;
- providing a (postal) address for an object company and performing "additional activities" such as record-keeping or preparing and filing tax returns (domicile plus);
- selling or intermediating in the sale of legal entities;
- acting as a trustee; and

- providing a conduit company.

Non-local service providers located in another EEA member state are prohibited from providing trust services in the Netherlands, unless a trust office licence has been obtained. Non-local service providers located outside the EEA cannot apply for such a licence, and thus are prohibited from offering trust services in the Netherlands. With respect to custody services, a licence pursuant to the second Markets in Financial Instruments Directive (2014/65/EU, MiFID II) may be required.

2.3.3 Local Regulatory Requirements for Non-Local Managers

An AIFM authorised in another EEA member state in accordance with Article 6 sub-paragraph 1 of the AIFMD may manage a Dutch AIF in the Netherlands on a cross-border basis with a passport, provided that the procedure of Article 33 of the AIFMD is followed, which, in summary, entails certain documentation and information being provided to the home member state regulator of the AIFM and notification to the AFM that the AIFM intends to manage a Dutch AIF.

An AIFM within the EEA that is not authorised in another EEA member state is not allowed to manage Dutch AIFs on a cross-border basis. The small managers regime as set out under **2.1.2 Common Process for Setting Up Investment Funds** is, pursuant to a recent change in Dutch law, available to “small” EEA AIFMs. As such, an EEA sub-threshold AIFM is allowed to manage a Dutch AIF, provided it complies with the conditions as set forth in the Registration regime for “small managers” as set out above and interests in the AIF are only marketed to professional investors.

A non-EEA AIFM may manage a Dutch AIF on a cross-border basis if such AIFM complies with the conditions of the Dutch NPPR. These conditions entail, in summary, certain reporting, disclosure and transparency requirements relating to the annual report, disclosures to investors (both initially and on an ongoing basis), reporting obligations to regulatory authorities and, where relevant, transparency and asset-stripping requirements relating to investments in portfolio companies, and where co-operation arrangements are in place between the supervisory authority of the non-EEA country where the AIFM is established and the AFM.

In addition, a notification should be filed with the AFM, including an attestation of the home country supervisor of the non-EEA AIFM. Furthermore, the non-EEA country where the AIFM is established should not be listed as a non-cooperative country for the purposes of the Financial Action Task Force (FATF). Finally, pursuant to the Dutch NPPR, units in the relevant AIFs may only be offered to “qualified investors”, within the meaning of the AFS.

2.3.4 Regulatory Approval Process

See **2.1.2 Common Process for Setting Up Investment Funds.**

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

See **2.1.2 Common Process for Setting Up Investment Funds.**

2.3.6 Rules Concerning Marketing of Alternative Funds

See **2.1.2 Common Process for Setting Up Investment Funds.** The regulatory regimes set out therein also apply if an AIF is marketed in the Netherlands. As a result, a Dutch AIFM should make use of the fully licensed regime or, if applicable, the small managers regime when marketing interests in AIFs in the Netherlands. A licensed AIFM in another EEA member state may market interests in EU AIFs in the Netherlands pursuant to the passporting regime set out in Article 32 of the AIFMD. Recently, Dutch law has changed to provide that sub-threshold AIFMs in other EEA member states may market interests in AIFs to professional investors in the Netherlands provided the conditions of the Dutch sub-threshold regime are met. Non-EEA AIFMs may only market interests in AIFs in the Netherlands while making use of the Dutch NPPR. If a licensed EEA AIFM intends to market a non-EEA AIF in the Netherlands, the Dutch NPPR should be complied with.

With respect to marketing communications by Dutch AIFMs, as a general rule, marketing information provided by an AIFM has to be accurate, clear and not misleading. Also, all information provided by the AIFM may not be contrary to the information that is required to be disclosed pursuant to the AFS, and it should be made clear whether documents are of a commercial nature. Marketing communications with respect to UCITS and AIFs marketed by licensed AIFMs or with respect to AIFs that apply the EuVECA or EuSEF regime should comply with the requirements of the ESMA Marketing Communication Guidelines.

Regarding the information to be made available when marketing interests in AIFs in the Netherlands, see again **2.1.2 Common Process for Setting Up Investment Funds**.

2.3.7 Marketing of Alternative Funds

See **2.2.3 Restrictions on Investors**.

2.3.8 Marketing Authorisation/Notification Process

See **2.1.2 Common Process for Setting Up Investment Funds**.

2.3.9 Post-Marketing Ongoing Requirements

For Dutch-licensed AIFMs, post-marketing ongoing requirements include, inter alia, informing investors of material changes in the information provided to investors in the marketing phase. A licensed AIFM furthermore needs to notify the AFM of material changes in the documents submitted to the AFM to obtain the approval from the AFM for the marketing and management of the AIF. The AFM in principle has one month to decide on whether it will object to the change, to be extended by another month. In addition, investors need to be informed of certain types of conflicts of interest before conducting business on their behalf. Finally, investors need to be provided on an annual basis with an AIF annual report, which complies with the requirements of Article 22 AIFMD (see **2.4 Operational Requirements**).

2.3.10 Investor Protection Rules

For Dutch AIFMs that are registered under the small managers regime, from a regulatory perspective, there are generally no investor protection rules that should be taken into account.

For AIFMs (including Dutch-licensed AIFMs) authorised under the fully licensed regime, the investor protection rules pursuant to the AIFMD apply. Generally speaking, no gold plating of the AIFMD has taken place in the Netherlands, which means that, inter alia, the following AIFMD investor protection rules on the following topics should be taken into account:

- operating conditions, including requirements regarding remuneration, conflict of interest and risk management;
- depositary;
- fair treatment of investors; and
- transparency requirements.

When interests are marketed to non-professional investors that invest less than EUR100,000, additional investor protection rules pursuant to the Dutch retail top-up regime need to be complied with (as discussed in **3. Retail Funds**).

2.3.11 Approach of the Regulator

The AFM may be described as a supervisor that duly considers the legal basis for its supervision and enforcement, while adopting a rather pragmatic approach if possible. This is no different when it comes to the supervision of AIFMs based on the Dutch implementation of the AIFMD.

2.4 Operational Requirements

For Dutch-licensed AIFMs, the operational requirements pursuant to the AIFMD apply. In general, provided that the offering is limited to professional investors, no gold plating of the AIFMD has taken place in the Netherlands. Generally, there are no restrictions on the types of activity or the types of investments for the AIF, provided that the envisaged activities/investments fall within the investment strategy covered by the AIFM's licence.

Licensed AIFMs must appoint a depositary for the AIF. In principle, in the Netherlands, such depositary is subject to a licence requirement, unless a specific exemption to the licence requirement is available. If the AIF has no legal personality, the legal ownership of the assets under management must be held by a separate legal entity whose sole object stated in the articles of association is holding the legal ownership of the assets of investment funds.

Dutch AIFMs registered under the small managers regime are, in principle, not subject to any specific operational requirements.

Certain other operational requirements are also relevant, such as customer due diligence requirements based on the Dutch implementation of the (revised) Fourth and Fifth Anti-Money Laundering and Terrorist Financing Directive, which is applicable to licensed AIFMs and AIFMs registered under the small managers regime.

2.5 Fund Finance

All types of investment funds in the Netherlands generally have access to fund financing and leveraged financing. Traditional subscription financing remains the main type of financing selected by investment funds in the Netherlands, but over the past few years there has been an overall increase in the use of financing by managers and investment funds, including fund-level leverage (such as hybrid credit lines and NAV financings). Traditionally, financings to Dutch investment funds are made available by Dutch banks; however, nowadays, foreign lenders including alternative lenders are also active on, or entering, the Dutch fund finance market.

An important aspect of incurring leverage at the level of a Dutch investment fund is that the relevant fund manager may be required to obtain an AIFMD licence as a consequence of breaching the AuM Thresholds. Other than that, for all practical purposes, there are no material regulatory restrictions on borrowings, provided that borrowed funds are attracted from professional market parties (eg, banks, pension funds and those persons that commit at least EUR100,000).

The security package for Dutch fund finance products is dependent on the type of financing. Typically, the security package for a subscription financing of a Dutch investment fund consists of a right of pledge over:

- bank accounts; and
- the receivables of the investment fund vis-à-vis the investors (ie, the contractual right of the investment fund to receive capital contributions).

Pursuant to Dutch law, security over receivables can be established by way of a disclosed or undisclosed right of pledge. Typically, in relation to subscription financing granted to a Dutch fund, a disclosed right of pledge over investor receivables is created. A disclosed right of pledge is created by way of a security agreement and notification of the right of pledge to the relevant debtors of the secured receivables. There is no prescribed form for notification, and no requirement to include a detailed description of the security agreement. Such notification can be made by uploading the notice to the relevant investor portal, making the process of serving notice a fairly effortless procedure. An undisclosed right of pledge is created by way of a notarial deed or by way of a security agreement that is registered with the Dutch tax authorities for date-stamping purposes.

In addition, depending on the type of financing and the structure of the investment fund, security could also be granted in respect of the assets in which an investment fund would (indirectly) invest. This will be the case for certain hybrid facilities and for NAV facilities where a debt provider is lending against the value of the underlying investments. NAV facilities are typically secured with a pledge over:

- the fund's distribution bank account;
- dividend rights; and
- the equity in the relevant bidco or a holding entity structured below the fund.

However, a wide variety of structures is being used in Dutch NAV facilities, including structures involving a newly set-up aggregator financing vehicle and more bespoke structures without equity pledges.

Additionally, an increasing number of Dutch fund managers are using GP/team co-investment facilities whereby often (directly or indirectly) the team's co-invest interest in the fund and/or management fees are used as collateral.

There are generally no structural or legal issues that commonly arise in relation to fund finance in the Netherlands.

2.6 Tax Regime

In 2025 the Dutch tax classification rules for Dutch and foreign entities have changed. Under the new rules, limited partnerships (including the Dutch CV) in principle qualify as tax transparent.

A Coop cannot be organised as a tax-transparent entity in the Netherlands. A Coop is subject to corporate income tax on worldwide income, provided it is fully exempt from Dutch corporate income tax on dividends and capital gains derived from the qualifying equity stakes in portfolio companies (the participation exemption). Typically, the investments made by buyout funds and venture capital funds in their portfolio companies are eligible for the participation exemption. Profit distributions made by a Coop are subject to Dutch dividend tax if the Coop qualifies as a mere holding vehicle. A Coop that is used as a principal fund vehicle by fund managers that are (substantially) based in the

Netherlands may, however, be eligible for an exemption.

Transparent Funds and FGRs

Under the new (2025) entity classification rules, investment funds in the form of an FGR may still qualify as tax opaque if they offer (freely) transferable participations to investors. If the participants cannot be transferred to other parties but only to the fund by way of redemption, the FGR qualifies as transparent.

For example, debt funds may be structured as a transparent FGR. As a consequence of its tax transparency, any income and gains realised by investing through the transparent FGR are attributed to the participants as if the participants were investing directly in the investment portfolio of the FGR.

Tax opaque FGRs are subject to Dutch corporate income tax on worldwide income, and profit distributions made by a tax opaque FGR are, in principle, subject to Dutch dividend withholding tax. However, if certain conditions are met, the tax opaque FGR can opt for the status of "exempt investment institution" (*vrijgestelde beleggingsinstelling*, or VBI) or "fiscal investment institution" (*fiscale beleggingsinstelling*, or FBI).

An FGR that elects to be treated as a VBI is fully tax-exempt – ie, the VBI is not subject to Dutch corporate income tax and its profit distributions are not subject to Dutch dividend withholding tax. A VBI may only invest in financial instruments, including transferable securities.

The FBI is subject to Dutch corporate income tax at a rate of 0%. The FBI may only hold mere portfolio investments. However, unlike the VBI, the FBI may also invest in real estate. Consequently, in practice, the FBI may be referred to as the Dutch REIT regime. Note, however, that, as mentioned in **2.1.1 Fund Structures**, it is expected this regime will be abolished for direct real estate investments in 2025. The FBI is required to meet statutory requirements as to its shareholders and leverage restrictions. Furthermore, the FBI must distribute its net income within eight months of the fiscal year-end. Profit distributions made by the FBI are, in principle, subject to 15% Dutch dividend withholding tax.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Retail funds (eg, UCITS funds) are often structured in the form of a tax opaque FGR or a public limited liability company (*naamloze vennootschap met beperkte aansprakelijkheid*, or NV) that adopts the legal status of an investment institution with variable capital (*beleggingsmaatschappij met variabel kapitaal*, or BMVK).

For more discussion on FGRs and the tax opaque FGR, see **2.1.1 Fund Structures**.

The NV has legal personality and capital divided into shares. Shareholders of an NV are required to hold at least one physical meeting each year. The NV is incorporated by the execution of a notarial deed of incorporation (including the articles of association of the NV) to that effect. The incorporation of an NV requires a bank account to be set up in the company's name prior to incorporation, a bank statement providing evidence of the payment of the minimum paid-in share capital (if in cash) or a description of the contribution drawn up and signed by the incorporators, and an auditor's certificate attesting to such payment (if in kind).

Both the tax opaque FGR and the NV BMVK are suitable for the setting up of (semi) open-end and closed-end funds, as well as for umbrella funds. Both the participations in the FGR and the shares in the NV BMVK can be listed on a stock exchange.

3.1.2 Common Process for Setting Up Investment Funds

Retail investment funds (or their fund managers) have to be authorised on the basis of either the Dutch implementation of the AIFMD and the AIFMD retail top-up regime, or the Dutch implementation of UCITS.

AIFMD

See **2.1.2 Common Process for Setting Up Investment Funds** regarding the registration and/or approval requirements for AIFMs and AIFs pursuant to the Dutch implementation of the AIFMD. As the authorisation pursuant to the AIFMD is, in principle, limited to professional investors, managers who intend to offer interest in the AIF they manage to non-professional investors (retail) in the Netherlands should comply with the so-called Dutch retail top-up regime. The licence for these authorised AIFMs should specifically include the retail top-up.

The authorised AIFM with a retail top-up will have to meet all requirements that apply for authorised AIFMs under the fully licensed regime. In addition, the retail top-up regime, inter alia, requires the manager to comply with detailed additional compliance, information and reporting requirements. However, the manager is not required to comply with the requirements under the retail top-up regime if interests are offered to non-professional investors for a countervalue of more than EUR100,000 per investor. However, AIFMs will have to prepare a KID (in the Dutch language) for each new AIF they are marketing, and provide this to non-professional investors prior to investing in the AIF. In this respect, see **3.1.4 Disclosure Requirements**.

UCITS

Pursuant to Section 2:69b of the AFS, it is prohibited to manage and market UCITS funds in the Netherlands without a licence from the AFM. A licence can be obtained by the UCITS fund manager (ManCo) or by the (self-managed) UCITS. The AFM will grant a licence upon application if the ManCo meets the licence requirements under Dutch law. The licence requirements relate to, inter alia, the suitability and trustworthiness of the board members, the operational and control structure, the appointment of a depositary, solidity and minimum own funds requirements. Holders of a qualifying holding (ie, more than 10% capital or voting rights) need to obtain a declaration of no objection from the DNB.

The AFM has a review period of 13 weeks for a licence application of a ManCo, and eight weeks for a licence application of a UCITS. The AFM may request additional documents or information during the application process. The review period is suspended while additional documents are being requested.

A licensed ManCo can manage a new UCITS within the investment strategy covered by its licence, and can market such UCITS to retail investors if it has submitted the notification form to the AFM at least two weeks prior to the marketing of the respective UCITS. The following should be attached to the notification form:

- a prospectus (pursuant to Section 4:49 of the AFS); and
- a Key Information Document (*Essentiële-informatiedocument*, or KID).

3.1.3 Limited Liability

FGR

See **2.1.3 Limited Liability** for a description of the FGR, and the limited liability of investors in an FGR.

NV

An NV is a legal entity with capital divided into one or more transferable shares, which has legal personality. A shareholder of an NV is, in principle, not liable for acts performed in the name of the company and does not have to contribute to the losses of the company in excess of the amount to be paid up on their shares. However, the liability of a shareholder for the obligations of the NV may arise if:

- such shareholder committed a tort;
- such shareholder qualifies as a policymaker or a co-policymaker of the company and there is evidently improper management of the company;
- such shareholder voluntarily assumes liability for the obligations of the company;
- in exceptional circumstances, where “hiding” behind separate legal identities constitutes an abuse of law, such shareholder may be identified with the company; or
- a shareholder receives a distribution in excess of the company’s freely distributable reserves while being aware – or when they should reasonably have been aware – that such distribution was not permitted.

When a shareholder supports or effects a dividend or other distribution while knowing that the NV would, as a consequence, not be able to continue paying its debts when these become due, it may qualify as acting in a tortious manner.

3.1.4 Disclosure Requirements

UCITS

The ManCo has to publish the following disclosures on its website:

- a prospectus including the information required pursuant to Article 4:49 of the AFS in conjunction with Article 118 of the Market Conduct Supervision Financial Institutions Decree (the “Decree”) and Annex I to the Decree (such as certain information about the fund, the (co-)policymakers, changes in conditions, the provision of information, the fund activities and investment strategy, costs and remuneration, participation rights, risk profile of the fund and valuation of assets);
- the fund rules or the articles of association of the UCITS; and
- if made public, the annual accounts of the UCITS of the two preceding years (based on Article 4:50 of the AFS).

Pursuant to the PRIIPS Regulation, a KID must be made available to retail investors before they invest in a UCITS fund and thereafter on a continuous basis.

AIFM With Retail Top-Up

In principle, a licensed AIFM with a retail top-up will have to meet all the (disclosure) requirements that apply to licensed AIFMs under the fully licensed regime (as set out in **2.1.2 Common Process for Setting Up Investment Funds**).

With respect to an AIF that is closed-ended and with tradable units, an approved prospectus should be published pursuant to the Prospectus Regulation (EU 2017/1129), unless an exemption applies.

With respect to an AIF whose units are not transferable and open-end AIFs, unless an exemption applies as a result of which there is no prospectus requirement, a prospectus including the information required pursuant to Article 23 of the AIFMD should be made available and published on the AIFM's website, to be supplemented with particular information deemed important for retail investors as set out in the retail top-up regime, such as:

- certain information about the AIF;
- the (co-)policymakers;
- the procedure regarding amendment of fund terms;
- reporting to investors;
- the fund activities and investment strategy;
- costs and remuneration;
- information with respect to the participation rights;
- risk profile of the fund; and
- valuation of assets.

Also, semi-annual accounts with respect to the AIFs will have to be published.

As mentioned above, a KID needs to be prepared and made available to retail investors before they invest in an AIF, and thereafter on a continuous basis.

AIFM Without Retail Top-Up

AIFMs registered under the small managers regime and authorised AIFMs under the fully licensed regime that market interests to retail investors for a countervalue of more than EUR100,000 per investor have to prepare a KID and make this available to investors before they invest in the AIF.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

In general, private individuals invest in liquid funds, for the purpose of their personal wealth management.

3.2.2 Legal Structures Used by Fund Managers

Dutch fund managers often adopt the legal form of a BV to carry on their risk and portfolio management activities for the benefit of the investment funds under management.

3.2.3 Restrictions on Investors

There are no restrictions on the types of investors that can invest in a retail fund.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

Retail investment funds (or their fund managers) have to be authorised on the basis of either the Dutch implementation of the AIFMD and the Dutch retail top-up regime if investors are able to invest less than EUR100,000, or the Dutch implementation of UCITS.

With respect to authorised AIFMs with a retail top-up, in principle, no investment limitations apply. A Dutch UCITS, however, should take into account specific investment limitations as set out in the Dutch implementation of the UCITS Directive.

3.3.2 Requirements for Non-Local Service Providers

See **2.3.2 Requirements for Non-Local Service Providers**.

3.3.3 Local Regulatory Requirements for Non-Local Managers

AIFMD

EEA AIFMs with a licence and that obtained a passport pursuant to Article 32 of the AIFMD can market to retail investors in the Netherlands once they have filed a retail distribution notification form with the AFM. If retail investors can invest in the AIF marketed for less than EUR100,000, the retail top-up regime needs to be complied with. EEA sub-threshold AIFMs cannot market AIFs to retail investors in the Netherlands.

Under certain circumstances, non-EEA AIFMs located in the USA, Guernsey, Hong Kong or Jersey may market AIFs to Dutch retail investors pursuant to the so-called designated state regime. Otherwise, non-EEA AIFMs are not allowed to market AIFs to Dutch retail investors.

UCITS

A non-local EEA-authorised ManCo may manage and market authorised UCITS funds in the Netherlands on a cross-border basis, provided that the passporting procedure (Article 91 and further of the UCITS Directive) is followed. The EEA ManCo will need to obtain separate approval from the AFM for the management of a Dutch UCITS fund in the Netherlands (pursuant to the Dutch implementation of Article 5(3) of the UCITS Directive). If a non-Dutch UCITS fund is marketed in the Netherlands, a KID will have to be provided in the Dutch language.

3.3.4 Regulatory Approval Process

AIFMD

With respect to the regulatory approval process for Dutch AIFMs under the fully licensed regime and the small managers regime, see **2.1.2 Common Process for Setting Up Investment Funds**.

UCITS

If a ManCo applies for a licence from the AFM pursuant to the AFS, the AFM has a review period of 13 weeks. With respect to a licence application for a UCITS, the AFM has a review period of eight weeks. During the application process, the AFM may request additional documents or information; the review period is suspended when the AFM is requesting additional documents. A licensed ManCo can manage a new UCITS if it has submitted the notification from the UCITS to the AFM at least two weeks prior to the marketing of the respective UCITS.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

See **3.3.6 Rules Concerning Marketing of Retail Funds**.

3.3.6 Rules Concerning Marketing of Retail Funds

As a general rule, information provided by an AIFM or ManCo has to be accurate, clear and not misleading. Also, all information provided by the AIFM or ManCo may not be detrimental to the information to be supplied or made available pursuant to the AFS, and it should be made clear whether documents are commercial. Additionally, rules regarding marketing materials apply. See **3.1.4 Disclosure Requirements**.

In addition, the Unfair Commercial Practice Act (*Wet oneerlijke handelspraktijken*, or UCPA) applies to all financial institutions that market, offer or sell products or services to consumers in the Netherlands, regardless of the authorisation, registration or exemptions that may be relied upon for Dutch financial regulatory purposes. If the AFM, as competent supervisory authority of the UCPA, deems that information provided to consumers is misleading or unfair, it may, for example, impose a fine on the fund in question (or its fund managers).

The Netherlands has not introduced a pre-marketing regime with respect to non-professional investors. Consequently, there are only limited possibilities for a fund manager to pre-market an investment fund to non-professional investors.

3.3.7 Marketing of Retail Funds

There are no restrictions on the types of investors that can invest in a retail fund.

3.3.8 Marketing Authorisation/Notification Process

See **3.1.2 Common Process for Setting Up Investment Funds.**

3.3.9 Post-Marketing Ongoing Requirements

For Dutch-licensed AIFMs, post-marketing ongoing requirements include, inter alia, informing investors of material changes in the information provided to investors in the marketing phase. Also, a licensed AIFM needs to notify the AFM of material changes in the documents submitted to the AFM, to obtain its approval for the marketing and management of the AIF. The AFM in principle has one month to decide on whether it will object to the change, to be extended by another month. In addition, investors need to be informed of certain types of conflicts of interest before conducting business on their behalf. Finally, investors need to be provided on an annual basis with an AIF annual report, which complies with the requirements of Article 22 AIFMD. See **3.4 Operational Requirements**.

AIFMs marketing AIFs under the retail top-up regime and ManCos must comply with certain additional ongoing requirements following the marketing of an investment fund aimed at protecting retail investors.

3.3.10 Investor Protection Rules

In principle, an authorised AIFM with a retail top-up will have to meet all the requirements that apply for authorised AIFMs under the fully licensed regime (see **2.3.10 Investor Protection Rules**).

Authorised AIFMs with a retail top-up and authorised ManCos have to comply with certain investor protection requirements pursuant to the AFS and the regulations promulgated thereunder, such as the requirement to have certain organisational and administrative procedures in place relating to, inter alia, conflicts of interest, complaints handling and product approval procedures. In addition, the requirement to be registered with the Dutch Financial Services Complaints Tribunal (*Klachteninstituut Financiële Dienstverlening*) applies.

3.3.11 Approach of the Regulator

The AFM may be described as a supervisor that duly considers the legal basis for its supervision and enforcement, while adopting a rather pragmatic approach if possible. See **2.3.11 Approach of the Regulator**.

3.4 Operational Requirements

In principle, the authorised AIFM with a retail top-up will have to meet all the requirements that apply for authorised AIFMs under the fully licensed regime and the rules set out in the retail top-up regime.

With respect to authorised Dutch UCITS funds, specific operational requirements apply, as set out in the Dutch implementation of UCITS. For instance, the legal ownership of the assets under management of the UCITS has to be held by a separate legal entity whose sole object as stated in the articles of association is holding the legal ownership of the assets of the UCITS fund.

Authorised Dutch UCITS funds have to appoint a depositary. In principle, in the Netherlands, such depositary is subject to a licence requirement, unless a specific exemption to the licence requirement is available.

Certain other operational requirements are relevant, such as customer due diligence requirements on the basis of the Dutch implementation of the (revised) Fourth and Fifth Anti-Money Laundering and Terrorist Financing Directive, which is applicable to Dutch UCITS funds.

3.5 Fund Finance

See **2.5 Fund Finance**.

3.6 Tax Regime

Retail funds that are structured as a tax opaque FGR or NV BMVK often elect to be treated as a VBI or an FBI.

An FBI is subject to Dutch corporate income tax at a 0% rate.

Profit distributions by an FBI are, in principle, subject to 15% Dutch dividend withholding tax, with two important exceptions.

- The FBI can apply a conditional rebate for the amount of directly suffered (foreign) withholding taxes against the FBI's own obligation to remit 15% Dutch dividend tax to the Dutch tax authorities, withheld in respect of its own profit distributions. Effectively, the (foreign) withholding tax levied in connection with the investments of the FBI will be converted into Dutch withholding tax, for which the retail investors may be eligible for a credit or (partial) refund. This is considered an apparent benefit of the FBI regime compared to other investment tax regimes (including the Dutch VBI regime), where (foreign) withholding taxes suffered in connection with the investment portfolio are often neither creditable nor refundable, as a consequence of which, such withholding taxes will be a fund cost, reducing the return on investment.
- The FBI can elect to apply a so-called reinvestment reserve (*herbeleggingsreserve*) by claiming such a reserve in its Dutch corporate income tax return. This reserve is equal to the net balance of (unrealised) gains and losses reduced with a proportionate part of the running costs of the FBI. By creating a reinvestment reserve, items of a capital nature will be excluded from the FBI's taxable profits and, therefore, will not fall under the annual distribution obligation. Furthermore, subject to certain provisos, the FBI can make distributions at the expense of the reinvestment reserve free from Dutch dividend withholding tax, so that items of a capital nature realised by the FBI are effectively subject to neither Dutch corporate income tax nor Dutch dividend withholding tax.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Legislation on Partnerships

Proposed legislative reforms in relation to Dutch partnership laws are being considered. One of the most remarkable amendments may be that a partnership obtains legal personality. However, it is currently unclear if and when these proposed amendments will be formalised.

SWEDEN

Finland
Sweden
Norway
Stockholm
Russia
Denmark
Latvia

Law and Practice

Contributed by:
Björn Wendleby, Rico Benavides, Per Josephson and Stellan Koch
Harvest Advokatbyrå

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Harvest Advokatbyrå was established in 2016 and is Scandinavia's largest independent specialist law firm, with a clear focus on advising financial institutions. Its 30-lawyer-strong banking and finance team advises clients ranging from innovative start-ups, payment institutions, banks, fund managers and investment firms to crypto-asset service providers and other companies active in the Swedish financial sector. It advises on a wide range of legal and financial regulatory issues important for the finance industry, including compliance, internal audits, application procedures, AML/CTF and sustainable finance, as well as on the outsourcing of technology services by financial institutions. The firm maintains frequent and close contact with the Swedish Financial Supervisory Authority (SFSA; Finansinspektionen), and a number of its employees are SFSA alumni. The scope of its services also includes advising companies in the banking and finance sector on corporate matters, such as setting up legal entities, transactional assistance and preparing and negotiating agreements. The firm also advises on data privacy and data protection issues. Harvest's office is located in Stockholm.

Authors

Björn Wendleby is a partner at and founder of Harvest Advokatbyrå. Björn specialises in financial regulation, mainly within exchange and securities law, banking and finance legislation, asset management, crypto-assets, sustainability regulation and AML. He has represented clients in contacts with the Swedish Financial Supervisory Authority (Finansinspektionen), advising in matters relating to authorisations with the Financial Supervisory Authority and in various implementation projects. Björn has participated in several long-term projects implementing new legislation, such as MiFID/MiFID 2, PSD/PSD 2, AIFMD and 4AMLD. His client portfolio includes banks, investment firms, payment institutions, fund managers and crypto-asset service providers. Björn is ranked in band 1 in Banking & Finance (Europe) and Regulatory (Sweden) by Chambers.

Rico Benavides is a member of the Swedish Bar Association who has been working on financial regulatory compliance matters since 2014. Rico specialises in financial regulation, especially in asset management (UCITS and AIFMD), investment services (MiFID), insurance (IDD) and anti-money laundering and counter-terrorist financing (AMLD). He advises foreign and domestic companies operating in the financial industry, such as investment firms, fund managers, banks, insurance companies and insurance distributors, in matters relating to regulatory compliance with the Swedish Financial Supervisory Authority including authorisation, the implementation of new legislation, cross-border business setups and corporate and contract law matters. Several of Rico's clients are fintech companies providing robo-advice, e-commerce payments or crypto-trading services.

Per Josephson is a senior associate at Harvest Advokatbyrå. He specialises in financial regulation, especially in the areas of fund management, asset management, securities, sustainable finance and AML/CFT. In his daily work, Per provides advice on a variety of matters relating to authorisations with the SFSA and on various implementation projects, as well as corporate and contract law issues. Per has extensive experience in fund regulation, market abuse and sustainability regulation from the SFSA. Per is also a member of the board of Swesif, Sweden's Sustainable Investment Forum, having the main responsibility with respect to Swesif's membership in Eurosif, a partnership of Europe-based national sustainable investment forums (SIFs).

Stellan Koch specialises in financial regulation, especially in the areas of asset management, securities and AML. In his daily work, Stellan advises several clients in the financial industry, such as fund managers, in matters relating to regulatory compliance. He also participates in projects implementing new legislation and with applications for authorisation with the Swedish Financial Supervisory Authority (Finansinspektionen).

Harvest Advokatbyrå AB

Engelbrektsplan 1
Box 7225
103 89 Stockholm
Sweden

Tel: +46 0820 4011
Email: info@harvestadvokat.se
Web: www.harvestadvokat.se

HARVEST
ADVOKATBYRÅ

Contributed by: Björn Wendleby, Rico Benavides, Per Josephson and Stellan Koch, **Harvest Advokatbyrå**

1. Market Overview

1.1 State of the Market

Sweden is a prominent and highly regarded jurisdiction for investment fund formation and management, recognised for its stability, transparency and investor-oriented policies. With a well-established legal framework and governance standards, it offers an environment conducive to both domestic and international fund activities.

The Swedish investment fund market is mature and diverse, with over 80% of fund assets being managed locally. The Swedish investment funds market has evolved to cater to institutional and retail investors, encouraging financial inclusion and supporting economic development. Swedish fund-based saving plays a vital role in household financial planning and pension systems, underscoring its integration into the broader economy.

Sustainability is a hallmark of the Swedish financial sector. Fund managers are at the forefront of incorporating environmental, social and governance (ESG) criteria into their strategies, aligning with Sweden's strong commitment to green finance and EU-wide sustainability goals. This emphasis has made Sweden an appealing option for investors prioritising ethical and sustainable investment opportunities.

Sweden's regulatory landscape is designed to balance investor protection with operational flexibility, offering an efficient and reliable platform for fund managers to operate on.

Sweden's robust domestic investor base, including pension funds, insurers, family offices and private investors, plays a key role in its fundraising landscape. These stakeholders actively support both local and international investment opportunities. Sweden's stability, regulatory efficiency and focus on innovation provide distinct advantages for many fund managers.

Sweden is a competitive and attractive option for fund formation and investment, offering a supportive environment for sustainable and innovative financial activities.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Alternative investment funds (AIFs) can take the legal form of a so-called special fund, a common contractual fund or an association, such as a limited liability company, trading partnership or limited partnership (*kommanditbolag*). Whether an association constitutes an AIF is, however, determined based on the object of the association – ie, if the object meets the criteria of an AIF pursuant to Article 4 of the Alternative Investment Fund Managers Directive (AIFMD; 2011/61/EU).

In Sweden, real estate funds and private equity funds are commonly structured as limited liability companies or limited partnerships.

AIFs are regulated by the Swedish Alternative Investment Fund Managers Act (AIFMA;*lag* (2013:561) *om förvaltare av alternativa investeringsfonder*), which primarily governs AIF managers (AIFMs). Additional regulation of AIFs is provided under the regulations of the Swedish Financial Supervisory Authority (SFSA;*Finansinspektionen*) regarding AIFMS (*Finansinspektionens författningssamling* (FFFS) 2013:10).

An AIF structured as, for example, a Swedish limited liability company or a limited partnership must also comply with applicable company law.

For a special fund that falls within the definition of an AIF, the Swedish Undertakings for Collective Investment in Transferable Securities (UCITS) Act and the SFSA's regulations regarding Swedish collective investment in transferable securities (UCITS) funds (FFFS 2013:9) apply where relevant.

2.1.2 Common Process for Setting Up Investment Funds

Registration

For a Swedish AIFM, registration with the SFSA is sufficient if the following criteria are met:

- the assets of the AIFs, including those acquired through financial leverage, do not exceed EUR100 million; or
- the assets of the AIFs do not exceed the equivalent of EUR500 million in Swedish krona, provided that the portfolios consist of AIFs that are unleveraged and have no redemption rights exercisable during for a period of five years following the date of initial investment in each AIF.

An application for registration to manage AIFs shall include the following:

- information regarding the AIFM, the AIFs and their investment strategies;
- the information set out in Article 5 (1) and (2) of Delegated Regulation 231/2013/EU regarding AIFMs (Annex IV need not be completed at registration);
- information about the investors' right to redemption; and
- a description of how marketing to retail investors is prevented.

Authorisation

If the assets of the AIFs exceed the aforementioned thresholds, Swedish AIFMs must apply for authorisation. Compared to the registration process, a licence application requires additional documentation, which is detailed in AIFMA and FFFS 2013:10.

An external AIFM can obtain authorisation for discretionary portfolio management. Additionally, such a manager can apply for authorisation to provide investment advice under the Swedish Securities Market Act and the SFSA's regulations on investment services and activities (FFFS 2017:2), which implement Markets in Financial Instruments Directive (MiFID) II (2014/65/EU).

Once the application has been filed and the application fee (currently SEK378,000) has been paid, the SFSA begins processing the application. The standard processing time is three months, but the SFSA may extend this by an additional three months under special circumstances. However, applicants should anticipate a handling time of six to nine months due to potential delays.

2.1.3 Limited Liability

As a main principle, an investor in an AIF is only liable to the amount invested. However, exceptions may occur based on the legal structure of the AIFM. For example, in relation to an internal AIFM legally structured as a limited partnership, the general partner and investor (*kommanditdelägaren*) is personally responsible for the agreements and debts of the limited partnership.

2.1.4 Disclosure Requirements

Disclosure Requirements

A disclosure document (prospectus) in accordance with the rules in Article 23 of the AIFMD is required if an AIF is to be marketed to professional investors within the EEA.

A more extensive prospectus is required if an AIF is to be marketed to retail investors. Marketing towards retail investors resident in Sweden is possible if the manager is managing a special fund or has been granted a specific additional licence to market a fund that is a company and has its shares listed on a regulated market.

The prospectus must contain the following minimum information, where applicable:

- general information on the investment fund;
- the investment policy of the investment fund;
- risks and investor profile;
- the manager, depositary and auditor;
- outsourcing;
- the issue, redemption and conversion of units; and
- past performance.

There are also specific minimum information requirements for the prospectus of closed-end public AIFs.

In addition to the prospectus, so-called key investor information must also be provided. The key investor information was supplemented by the key information document (KID) in accordance with the European Packaged Retail and Insurance-based Investment Products (PRIIP) Regulation.

For retail funds, the prospectus shall inform the investors about the "facilities" established for local investors under the EU Directive on cross-border distribution of investment funds (Directive (EU) 2019/1160).

Reporting Requirements

Each AIFM must, within six months from the end of each fiscal year, submit an annual report for:

- each EEA-based AIF managed by the AIFM; and
- each AIF marketed by the AIFM within the EEA.

The annual report must be made available to the AIF's investors upon request. Additionally, the SFSA and, if applicable, the home country authority of the AIF (if domiciled outside Sweden), must receive the report.

For special funds, an AIFM must submit a quarterly report to the SFSA at the end of each calendar quarter. This report must include:

- a profit and loss account and a balance sheet with specifications; and
- information on the calculation of own funds and capital requirements.

The quarterly report must reflect the conditions as of the last day of the quarter and be submitted by the following deadlines: 21 April, 21 July, 21 October and 21 January.

In addition, AIFMs must provide regular reports to the SFSA regarding:

- the principal markets where the AIFM operates;
- the financial instruments traded; and
- each fund's principal exposures and risk concentrations.

AIFMs must provide the SFSA with the following information for each EEA-established AIF they manage, and for each fund they market within the EEA:

- the percentage of the fund's assets that are illiquid;

- any amendments or new arrangements for liquidity management;
- the fund's risk profile and the risk management systems used;
- details of the main categories of assets in which the fund invests; and
- the results of stress tests performed on the fund.

Upon request by the SFSA, AIFMs must also provide:

- a detailed list of the AIFs managed, updated at the end of each quarter; and
- annual reports for each fund managed and marketed within the EEA.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Alternative funds in Sweden attract capital from institutional investors such as pension schemes, insurance companies, taxable and tax-exempt pension funds and banks, and from private investors such as family offices and high net worth individuals. Institutional investors typically invest via managed accounts, often as single- or group-investor funds.

2.2.2 Legal Structures Used by Fund Managers

An AIFM can be either internal or external. An internal AIFM administers the AIF itself as part of its legal structure (eg, a limited liability company that constitutes the AIF). An external AIFM, on the other hand, is a separate entity from the AIFs it manages (eg, a Swedish limited liability company authorised to manage AIFs).

2.2.3 Restrictions on Investors

There are restrictions on marketing to retail investors. AIFMs marketing AIFs to professional investors must implement measures to prevent the marketing of units and shares in the AIF to retail investors.

Sweden-Based AIFMs

Swedish AIFMs authorised under AIFMA can market special funds to retail investors resident in Sweden. Other AIFs may also be offered to the public, but only if the AIF has been admitted to trade on a regulated market.

A Swedish AIFM registered under AIFMA may also, with approval from the SFSA, market units to a retail investor who (i) commits to investing a minimum of EUR100,000, and (ii) provides written acknowledgment, in a separate document, of the risks associated with the investment. In that case, however, the investor must lack the right to redemption for at least five years from the first investment, and the fund must – according to its investment policy – generally invest in issuers or unlisted companies to acquire control.

EES-Based and Non-EES-Based AIFMs

The marketing of units or shares in AIFs to retail investors by EES-based and non-EES-based AIFMs requires authorisation from the SFSA. If a foreign AIF is considered equivalent to a special fund, it is possible to apply for authorisation to market the fund to the public, even if it is not admitted to trade on a regulated market. However, in practice, the SFSA rarely approves such applications.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

AIFs are regulated by AIFMA, although AIFMA primarily addresses AIFMs. Further regulation of AIFs is stipulated under the SFSA's regulations regarding AIFMs (FFFS 2013:10).

AIFs structured as, for example, a Swedish limited liability company or a limited partnership must also comply with applicable company law.

For a special fund, which falls within the definition of an AIF, relevant parts of the Swedish UCITS Act and the SFSA's regulation regarding Swedish UCITS funds (*värdepappersfonder*) (FFFS 2013:9) apply.

There are generally no investment limitations for AIFs. However, there are investment restrictions with regard to Swedish special funds. A Swedish special fund must adhere to the following requirements:

- the fund's sole purpose must be to invest in liquid financial assets only (in principle, eligible assets as defined under the UCITS Directive (2009/65/EU), although the SFSA may grant exemptions from the UCITS requirements);
- the fund must apply the principle of risk diversification;
- the fund units are repurchased or redeemed at the unit holder's request at least once every year; and
- the fund must adhere to specific requirements concerning the acquisition of non-listed companies and issuers.

2.3.2 Requirements for Non-Local Service Providers

In general, there is no registration or regulation requirement for non-local service providers such as administrators, custodians and services providers in Sweden. However, when a Swedish manager outsources portfolio or risk management, the service provider must be authorised or registered in their home country. Additionally, any service provider domiciled outside the EU must appoint a domestic authorised agent to whom notifications and service of process can be directed by the respective Swedish authority.

An outsourcing partner who provides services falling under MiFID will be subject to a licence requirement under the SFSA regulations.

If Swedish regulatory law requires a depositary for a Swedish AIF, the depositary – or at least a branch thereof – must be domiciled in Sweden.

2.3.3 Local Regulatory Requirements for Non-Local Managers

EU Managers

EU managers are allowed to perform management services in Sweden under the AIFMD passport regime with regard to AIFs. They may also use the AIFMD passport to provide other services and ancillary services (such as MiFID investment advice or discretionary individual portfolio management). EU managers can also apply with the SFSA to manage a Swedish special fund.

Non-EU Managers

Non-EU managers are currently not allowed to manage AIFs in Sweden. This might change in the future with regard to AIFMs in those countries for which the passporting regime under the AIFMD for third-country managers will eventually become effective.

2.3.4 Regulatory Approval Process

The handling time for the application for regulatory approval is three months, but under special circumstances the SFSA can extend the processing time by an additional three months. However, it should be noted that the process can be delayed, and applicants should expect a handling time of six to nine months.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

An AIFM may engage in preliminary marketing of EEA-based AIFs under certain conditions. This marketing must not enable investors to commit to acquiring fund shares, include subscription forms or provide final versions of key documents like fund rules or company by-laws. Draft documents must clearly state that they are incomplete and not an offer to invest. The EU pre-marketing rules also apply to non-EEA managers.

Managers must ensure that potential investors cannot acquire fund shares through preliminary marketing and must only use marketing methods permitted in Sweden. All such activities must be documented, and the SFSA must be notified within two weeks, detailing the marketing period, strategies and funds involved.

Preliminary marketing can be delegated, but only to certain authorised entities such as investment firms, credit institutions or authorised AIFMs. Delegated parties must also comply with the requirements for documenting and notifying with respect to preliminary marketing activities.

2.3.6 Rules Concerning Marketing of Alternative Funds

In Sweden, marketing is considered to encompass any activities designed to directly or indirectly offer or place units or shares in an investment fund. Reverse solicitation is currently not regarded as marketing, but its scope is limited due to the pre-marketing regime.

Marketing materials must be in line with the European Securities and Markets Authority (ESMA) guidelines on fair and not misleading content of marketing materials and shall also, in relation to Swedish special funds, be in line with the Guidelines for Marketing and Information by Fund Management Companies of the Swedish Investment Fund Association (*Fondbolagens Förening*).

There are restrictions on marketing to retail investors. AIFMs marketing AIFs to professional investors must take measures to prevent units and shares in the AIF from being marketed to retail investors.

2.3.7 Marketing of Alternative Funds

Sweden-Based AIFMs

Swedish AIFMs authorised under AIFMA can market AIFs to professional investors and AIFs that are special funds to retail investors. Other AIFs can also be offered to the public, but the AIF must have been admitted to trade on a regulated market, and a specific approval must have been granted by the SFSA.

A Swedish AIFM authorised under AIFMA can also, after approval by the SFSA, market units to a retail investor who (i) undertakes to invest a minimum of EUR100,000, and (ii) in writing, in a separate document, confirms their awareness of the risks associated with the investment. In that case, however, the investor must lack the right to redemption for at least five years from the first investment, and the fund must – according to its investment policy – generally invest in issuers or unlisted companies to acquire control.

EES-Based AIFMs

An EES-based AIFM can market EEA AIFs to professional investors in Sweden under the AIFMD passport regime. The marketing of non-EEA AIFs towards professional investors requires authorisation from the SFSA. Furthermore, marketing towards retail investors requires authorisation from the SFSA and can be granted if the fund is a special fund, a fund equivalent to a special fund or a fund listed on a regulated market.

More information about the application process can be found in **3.3.8 Marketing Authorisation/Notification Process**.

Non-EES-Based AIFMs

Non-EU managers that want to market a non-EEA AIF in Sweden towards professional investors must apply for an approval by the SFSA. More information about the application process can be found in **3.3.8 Marketing Authorisation/Notification Process**.

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2.3.8 Marketing Authorisation/Notification Process

Authorisation or registration is required by the SFSA prior to the marketing of alternative funds. Please see **2.1.2 Common Process** concerning the setting-up of investment funds.

2.3.9 Post-Marketing Ongoing Requirements

For Swedish authorised AIFMs, ongoing post-marketing requirements include, inter alia, informing investors of material changes in the information provided to investors in the marketing phase. Furthermore, a licensed AIFM needs to notify the SFSA of material changes in the documents submitted thereto, to obtain approval from the SFSA for the marketing and management of the AIF. The SFSA in principle has one month to decide as to whether it will object to the change, which can be extended by another month. In addition, investors need to be informed of certain types of conflicts of interest before conducting business on their behalf. Finally, investors need to be provided with an AIF report, on an annual basis, which complies with the requirements of Article 22 of the AIFMD.

2.3.10 Investor Protection Rules

For AIFMs authorised in Sweden under the fully licensed regime, the investor protection rules pursuant to the AIFMD apply. Generally speaking, no gold plating of the AIFMD has taken place in Sweden, which means that, inter alia, AIFMD investor protection rules on the following topics should be taken into account:

- operating conditions, including requirements regarding remuneration, conflict of interest and risk management;
- the requirement to appoint a depositary;
- fair treatment of investors; and
- transparency requirements.

2.3.11 Approach of the Regulator

The SFSA generally complies with established deadlines but retains discretion to determine when sufficient material has been submitted in a given case, marking the start of the processing period. As a result, actual processing times may in practice exceed those prescribed by laws and regulations.

The SFSA does include face-to-face meetings in their supervisory activities, as well as during the application process. Such meetings are also possible before an application is filed.

2.4 Operational Requirements

For Swedish-licensed AIFMs, the operational requirements under the AIFMD apply. Sweden does not impose additional requirements beyond the AIFMD. There are no restrictions on the types of activities or investments for the AIF, provided they align with the investment strategy covered by the AIFM's licence.

Licensed AIFMs must appoint a depositary for each AIF they manage. In Sweden, such depositaries are subject to licensing requirements.

Other relevant operational requirements include customer due diligence measures based on Sweden's implementation of the Anti-Money Laundering and Terrorist Financing Directive, which applies to AIFs.

AIFMs registered in Sweden are not subject to specific additional operational requirements.

2.5 Fund Finance

In Sweden, the fund finance market for AIFs is well-established and subject to regulatory oversight.

Swedish AIFs can generally access borrowing through banks and other financial institutions. Larger and more established funds, especially those managed by licensed AIFMs, tend to have better access to financing due to their compliance with regulatory standards and market reputation.

Borrowing by AIFs in Sweden is primarily governed by the AIFMD, as implemented in Swedish law. Restrictions depend on the fund's investment strategy and the agreements with investors. For instance, leveraged funds must disclose their borrowing levels to both investors and regulators, and there are caps on borrowing depending on the fund type.

It is common for lenders to require security when financing funds, such as pledges over fund assets or guarantees from parent companies. Lenders often conduct thorough due diligence to evaluate risks before extending credit, particularly for private equity or venture capital funds.

There are no common issues in relation to fund finance.

2.6 Tax Regime

All Swedish special funds are exempt from taxation and are not liable to pay Swedish income tax. AIFs that do not meet the requirements of special funds are subject to the Swedish corporate tax of 20.4% if domiciled in Sweden.

External and internal AIFMs are taxed based on the applicable tax rules for their specific legal structure. For example, an external AIFM operating as a Swedish limited liability company is subject to a corporate tax rate of 20.4%.

Investors in special funds domiciled in Sweden without an investment savings account are required to pay income tax – ie, a flat annual amount equal to 0.4% of the value of their shares at the beginning of the calendar year. This flat income is then taxed at 30% for individuals and 22% for legal entities. Additionally, dividends from shares or units in the special fund are taxable. Any profit from a transfer initiated by the investor is also subject to taxation, with the calculation varying depending on whether the special fund is listed or unlisted.

Non-residents are generally taxed in their country of residence. Under the Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standard (CRS) agreements, the Swedish Tax Agency is obligated to report information on taxable accounts held by non-residents to the designated foreign competent authority specified in the agreements.

Pension fund investors domiciled in Sweden are exempt from capital gains tax on transfers and pension pay-outs but are subject to tax on the return on capital and income tax on pension disbursements.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Investment funds that can be marketed to retail investors without a marketing licence are either UCITS or special funds.

UCITS and Swedish special funds are common contractual funds and may not acquire rights or assume obligations. Nor shall the fund have legal capacity to sue in, or be brought before, courts of law or any other public authority.

The main advantage of the contractual fund is that it is a well-known structure and not liable to pay any tax. A common criticism is that a Swedish UCITS cannot be established through a limited liability company, for example as a *société d'investissement à capital variable* (SICAV; investment company with variable capital) or Irish collective asset-management vehicle (ICAV). However, this issue is currently under investigation by an inquiry chair. More information regarding this matter can be found in **4.1 Recent Developments and Proposals for Reform.**

3.1.2 Common Process for Setting Up Investment Funds

Setting up a retail fund in Sweden, either as a regular UCITS or a special fund, requires approval of the fund rules by the regulator. The fund rules for a new fund shall be approved if the rules are equitable for the fund's shareholders. An application of approval shall contain:

- information on the board meeting at which the fund rules were adopted, or the minutes of that meeting;
- the fund rules in accordance with Chapter 4, Section 8 of the Swedish UCITS Act (*lag* (2004:46) *om värdepappersfonder*) and Chapter 23 of the FFFS 2013:9;
- the fund's prospectus (*informationsbroschyr*); and
- a KID according to EU PRIIP Regulation 1286/2014.

When applying for approval to manage a Swedish UCITS for the first time, a foreign management company authorised in its home state to manage foreign UCITS funds, and with authorisation to conduct operations in Sweden, must also include:

- a certificate showing that the management company in its home country is authorised to manage UCITS funds; and
- the agreement with the custodian as well as information about any outsourcing arrangements related to the management or related administration of the fund.

The SFSA shall make its decision within 60 days from the day that a complete application was filed.

The application fee has recently increased significantly and is currently SEK49,000 (approximately EUR4,250).

3.1.3 Limited Liability

The fund shareholders are not responsible for obligations relating to the fund. The management company of the fund represents the shareholders in all matters relating to the fund, and the fund cannot acquire rights or assume obligations. Nor does the fund have any legal capacity to sue in, or be brought before, courts of law or any other public authority.

3.1.4 Disclosure Requirements

A fund management company must provide investors with an annual report within four months of the expiry of the financial year and a half-yearly report on the first six months of the financial year within two months following the expiry of the half-year.

The annual and half-yearly reports must contain all information necessary to assess the fund's development and financial position.

A fund management company shall submit a quarterly report for its operations to the SFSA at the end of every quarter. The quarterly report shall contain a profit and loss account and a balance sheet with specifications, as well as information regarding the calculation of own funds and capital requirements. The quarterly report shall relate to the conditions on the last day of every calendar quarter (the report date), and the SFSA shall have received the report no later than 21 April, 21 July, 21 October or 21 January.

A fund management company must also be able to, at any given time, present a list of each investment fund's asset holdings (as stated in the Swedish UCITS Act).

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

Sweden has a long history of public distribution of investments funds, particularly through the public pension system. Swedish retail investors are therefore generally well informed. Investors are often willing to take risks, but retail funds are considered a good basis for retail investors to build on. It is not uncommon for retail investors to have a monthly automatic purchase of shares.

3.2.2 Legal Structures Used by Fund Managers

As stated in the foregoing, UCITS and special funds can only be common contractual funds.

3.2.3 Restrictions on Investors

While UCITS funds must be distributed to the public, special funds can be restricted to an objectively defined group of investors as long as it is not too small, which would be considered discretionary portfolio management. The target investor group of special funds must be stated in the fund rules of the fund.

Both UCITS and special funds can have different share classes, with different terms for:

- dividends;
- fees;
- the minimum subscription amount;
- the distribution of shares;
- currency hedging; and/or
- the currency in which the units are subscribed and redeemed.

Note that share classes with a minimum subscription of SEK50,000 or more are not considered available to the public, and UCITS must have at least one open share class.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

Swedish UCITS are regulated by the Swedish UCITS Act and the SFSA regulations on UCITS funds (FFFS 2013:9).

Swedish special funds are technically AIFs, regulated by Chapter 12 of AIFMA (SFS 2013:561) and the SFSA regulations on AIFMs (FFFS 2013:10). These provisions refer to the Swedish UCITS Act and the SFSA's regulations on

UCITS funds (FFFS 2013:9), relevant parts of which therefore apply.

Each Swedish UCITS shall maintain a suitable diversification of investments, taking into consideration the spreading of risk associated with the fund's investment focus pursuant to the fund rules.

Assets of a Swedish UCITS may, subject to the limitations stipulated in the UCITS Directive and regulations issued by the SFSA, be invested in liquid financial assets, which consist of transferable securities, money market instruments, derivative instruments and units in collective investment undertakings. The fund may also include liquid assets necessary for the management of the fund. Assets may also be invested in deposits with Swedish credit institutions and foreign credit institutions having their registered offices within the EEA, and with other foreign credit institutions if they are subject to prudential rules equivalent to those laid down by local law.

The same rules apply to special funds, but the SFSA can authorise special funds to deviate from these investment restrictions if the principle of risk diversification is considered to be upheld. The kind of deviations that the SFSA will approve is decided on a case-by-case basis.

3.3.2 Requirements for Non-Local Service Providers

Non-local service providers are generally not subject to any local regulation or registration requirements, However, when a Swedish manager outsources portfolio or risk management, the service providers must be authorised or registered in their home country. Additionally, any service provider domiciled outside the EU must appoint a domestic authorised agent to whom notifications and service of process can be directed by the relevant Swedish authority.

An outsourcing partner who provides services falling under MiFID will be subject to a licence requirement under the SFSA regulations.

The depositary for a retail fund – or at least a branch of the depositary – must be domiciled in Sweden.

3.3.3 Local Regulatory Requirements for Non-Local Managers

Non-local managers of retail funds in Sweden are obliged to follow the same regulatory requirements as local managers.

3.3.4 Regulatory Approval Process

Setting up a retail fund in Sweden, either as a regular UCITS or a special fund, requires approval of the fund rules by the regulator. The SFSA shall make its decision within 60 days from the day that a complete application was filed. Normally, the regulator will use all 60 days.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Pre-marketing of retail funds in Sweden is not regulated.

3.3.6 Rules Concerning Marketing of Retail Funds

The regulatory frameworks that apply to the marketing of public funds in Sweden are:

- the Swedish Marketing Practices Act;
- the Swedish UCITS Act;
- AIFMA; and
- the Guidelines for Marketing and Information by Fund Management Companies of the Swedish Investment Fund Association.

All marketing shall be designed and formulated in accordance with good marketing practice (laws and other ordinances, legal precedents, good business practice, etc). In the marketing of funds to customers, relevant and factual information shall be provided, and the risks associated with the product offered shall be explained. The information shall be expressed clearly.

In the marketing of funds, it shall always be made clear that such investments involve a risk.

3.3.7 Marketing of Retail Funds

Retail funds are free to be marketed to the general public. However, restrictions are stipulated in the so-called target market rules in MiFID II, as implemented in the Swedish Securities Act (SFS 2007:528) and the SFSA regulations regarding investment services and activities (FFFS 2017:2), which are applicable to securities firms as well as AIFMs and fund companies with ancillary authorisation for portfolio management or investment advice.

3.3.8 Marketing Authorisation/Notification Process

UCITS

There is no authorisation required for Swedish fund companies to market Swedish-domiciled UCITS funds in Sweden.

The marketing licence for EEA-domiciled UCITS can be passported into Sweden according to the UCITS Directive, as implemented in the member state of the fund manager.

AIFs Marketed to Retail Investors

Foreign counterparts to special funds (AIFs) established within the EEA

An EEA-based AIFM may, with permission from the SFSA, market units or shares in a foreign EEA-based AIF managed by the AIFM to non-professional investors in Sweden. Permission may only be granted if:

- the fund's sole purpose is to make collective investments in UCITS assets with capital from the general public or from a certain specified and defined circle of investors;
- the fund applies the principle of risk diversification;
- at the request of the unit or shareholders, the fund's units or shares are repurchased or redeemed with funds from the fund's assets;
- the AIFM provides functions in Sweden to (i) process orders to subscribe, repurchase or redeem units or shares and make payments to the unit or shareholder owners; (ii) provide investors with information on how orders can be placed and on payment for the repurchase or redemption of units or shares; (iii) facilitate the handling of information on how investors can exercise the rights arising from their investments in the fund; (iv) provide the information that the fund manager is required to provide; and (v) provide investors with relevant information about the tasks performed by the functions; and
- there is a fact sheet (KID) for the fund.

An EEA-based AIFM may, with permission from the SFSA, market units or shares in a non-EEA-based AIF managed by the AIFM to non-professional investors in Sweden. Permission may only be granted if:

- there is reason to assume that the AIFM will fulfil all requirements according to AIFMA and other statutes that regulate the business;
- the requirements for foreign EEA-based AIFs (as stated in the foregoing) are met;
- there are appropriate co-operation arrangements between the SFSA and the supervisory authority in the country where the fund or

recipient fund or its manager is established; and
- the country where the fund or recipient fund, or its AIFM, is established has taken the necessary measures to counter money laundering and terrorist financing.

Permission to market units or shares in a non-EEA-based AIF may also be granted if the requirements regarding depositaries are not fulfilled, and if the AIFM has ensured that one or more entities have been appointed to monitor the AIF's cash flows; deposit all financial instruments; monitor the ownership rights of other assets; execute the instructions of the AIFM; ensure the accurate sale, issuing, repurchase, redemption and cancellation of units; ensure the correct valuation of units/shares; ensure immediate remuneration of transactions affecting the AIF; and ensure the AIF's income is used in accordance with the provisions of AIFMA and the AIF's prospectus or equivalent regulations. The trustee must inform the SFSA regarding who is responsible for these tasks.

Foreign EEA-based AIFMs may also, with permission from the SFSA through the approval of the fund's rules, manage a Swedish special fund.

AIFs admitted to trading on a regulated market or an equivalent market outside the EEA

An EEA-based AIFM may, with permission from the SFSA, market units or shares in an AIF managed by the AIFM to non-professional investors in Sweden in cases other than those mentioned in the foregoing, if the units or shares in the fund are admitted to trading on a regulated market or an equivalent market outside the EEA and there is a fact sheet (KID) for the fund.

If the marketing concerns units or shares in a non-EEA-based AIF – or in a feeder fund to an AIF whose recipient fund, or its manager, is not EEA-based – the same requirements that apply to non-EEA based AIFs, as detailed in the foregoing, also apply here (except the requirements for foreign EEA-based AIFs).

Other AIFs that may be marketed towards certain non-professional investors

An EEA-based AIFM may, with permission from the SFSA, market units or shares in an EEA-based AIF managed by the AIFM to non-professional investors that commit to investing an amount equivalent to at least EUR100,000 and confirm in writing that they are aware of the risks associated with the commitment or investment ("semi-professional" investors) if the AIF is closed for redemptions, for at least five years from the first investment, and generally invests in companies to acquire control.

Such marketing is also permitted for a non-EEA-based AIF if there are appropriate co-operation arrangements between the SFSA and the supervisory authority in the country where the fund or recipient fund – or its manager – is established, and the country where the fund or recipient fund, or its AIFM, is established has taken the necessary measures to counter money laundering and terrorist financing.

3.3.9 Post-Marketing Ongoing Requirements

Upon request, the full prospectus, the key investor information document, the most recent annual report and, where applicable, the half-yearly report published thereafter shall be provided or sent free of charge to any party intending to purchase units in a UCITS or special fund. An investor shall also, without request, be offered the KID in due time prior to investment in a retail fund.

Upon demand by a unit holder or a party intending to purchase units in a Swedish UCITS or special fund, the management company shall provide supplemental information regarding the risk management of the fund, including the quantitative limitations applicable to investments of fund assets, the management methods chosen and the most recent trends in risk levels and yields in the most important categories of assets in which fund assets are invested.

3.3.10 Investor Protection Rules

There are no particular investor protection rules related to certain categories of investors in certain types of retail funds. However, the fund manager must act exclusively in the common interest of the fund unit owners.

UCITS

A fund management company must provide investors with:

- an annual report within four months of the expiry of the financial year; and
- a half-yearly report on the first six months of the financial year within two months following the expiry of the half-year.

The annual and half-yearly report must contain all information necessary to assess the fund's development and financial position.

A fund management company shall submit a quarterly report for its operations to the SFSA at the end of every quarter. The quarterly report shall contain a profit and loss account and a balance sheet with specifications, as well as information regarding the calculation of own funds and capital requirements. The quarterly report shall relate to the conditions on the last day of every calendar quarter (the report date), and the SFSA shall have received the report no later than 21 April, 21 July, 21 October or 21 January.

A fund management company must also be able to present a list of each UCITS' asset holdings (as stated in the Swedish UCITS Act) at any time.

Special Funds

Each AIFM shall, within six months of the end of each fiscal year, provide an annual report for each:

- EEA-based AIF managed by the AIFM; and
- AIF marketed by the AIFM within the EEA.

The fund's investors shall be provided with the annual report on request. The SFSA shall subsequently be provided with the annual report, as well as the home country authority if the fund's home country is not Sweden.

An AIFM that manages a special fund shall submit a quarterly report for each special fund to the SFSA at the end of every quarter. The quarterly report shall include the same information as the quarterly report for UCITS.

An AIFM shall provide regular reports to the SFSA on:

- the principal markets where the AIFM trades;
- the financial instruments the AIFM trades in; and
- each fund's principal exposure and concentration of risks.

AIFMs shall, for each EEA-established AIF managed by the AIFM and for each of the funds it markets in the EEA, provide the following information to the SFSA:

- the percentage of the fund's assets that are illiquid in nature;
- any amendments or new arrangements for managing the liquidity;
- the fund's risk profile and the risk management systems employed to manage those risks;
- information on the main categories of assets in which the fund invests; and
- the results of stress tests performed for the fund.

AIFMs shall, on the SFSA's request, provide the following documents:

- a detailed list of the AIFs managed by the AIFM updated at the end of each quarter; and
- the annual reports for each fund managed by the AIFM and marketed in the EEA.

3.3.11 Approach of the Regulator

The SFSA generally complies with established deadlines but retains discretion to determine when sufficient material has been submitted in a case, marking the start of the processing period. As a result, actual processing times may, in practice, exceed those prescribed by laws and regulations.

The SFSA does include face-to-face meetings in their supervisory activities as well as during the application process. Such meetings are also possible before an application is filed.

3.4 Operational Requirements

For fund companies and AIFMs authorised in Sweden, the operational requirements under the AIFMD and the UCITS Directive, respectively, apply, as implemented in Swedish laws and regulations. Sweden does not impose additional requirements beyond these, but EU market abuse rules according to the Market Abuse Regulation and anti-money laundering and terrorist financing rules apply.

Both fund companies and AIFMs need to appoint a depositary for each fund under management. In Sweden, such depositaries are subject to licensing requirements. The depositary for a Swedish UCITS must have its legal seat in Sweden or, if it is a branch established in Sweden, in another country within the EEA. The depositary for an AIF, or at least a branch of the depositary, must be domiciled in Sweden.

3.5 Fund Finance

UCITS

UCITS and Swedish special funds are common contractual funds and may not acquire rights or assume obligations. However, the fund manager may take up loans on behalf of the fund.

AIFs Marketed to Retail Investors

In Sweden, the fund finance market for AIFs is well-established and subject to regulatory oversight.

Swedish AIFs can generally access borrowing through banks and other financial institutions. Larger and more established funds, especially those managed by licensed AIFMs, tend to have better access to financing due to their compliance with regulatory standards and market reputation.

Borrowing by AIFs in Sweden is primarily governed by the AIFMD, as implemented in Swedish law. Restrictions depend on the fund's investment strategy and the agreements with investors. For instance, leveraged funds must disclose their borrowing levels to both investors and regulators, and there are caps on borrowing depending on the fund type.

It is common for lenders to require security when financing funds, such as pledges over fund assets or guarantees from parent companies. Lenders often conduct thorough due diligence to evaluate risks before extending credit.

There are no common issues in relation to fund finance.

3.6 Tax Regime

All Swedish UCITS and special funds are exempt from taxation and are not liable to Swedish income tax. Corporate tax was 20.4% in 2024, and for individuals, profits are normally taxed through general capital gains tax, which is 30%.

There is no separate tax regime specifically for investors in retail funds. However, all financial instruments (including units in UCITS or special funds) invested through an investment savings account *(investeringssparkonto* (ISK)) are taxed annually based on the combined value of the assets and deposits (the capital base), regardless of whether a profit or a loss is made. A standard income (*schablonintäkt*) is used to calculate the tax base, which was 3.62% of the capital base in 2024. This is then taxed at a rate of 30%, which means that the capital base for 2024 is taxed at 1,086% in total.

Corporates cannot open investment savings accounts, but they can open an endowment insurance policy.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Regulatory Changes

On 15 December 2023, the government announced that it had decided to appoint an inquiry chair to propose measures to modernise the fund regulations and thereby strengthen the competitiveness of the Swedish fund market. The issue has long been raised by the Swedish Investment Fund Association, which has pointed out that there are weaknesses in the Swedish fund regulations.

The inquiry chair will analyse and propose the legislative amendments needed to adapt Swedish law to changes in the AIFMD and the UCITS Directive. The inquiry will also analyse and propose measures to strengthen the competitiveness of the Swedish fund market, including rules on association funds with variable share capital. The inquiry will also review the rules on redemption frequency for UCITS funds and special funds, and analyse how the resilience of Swedish funds and the protection of investors can be strengthened. The aim is to modernise fund legislation, make the Swedish fund market more competitive and resilient and adapt the legislation to EU law.

The report is due by 30 April 2025.

Tax Changes

From 2025, a tax-free threshold will be introduced for the total savings that a person has in investment savings accounts (and endowment insurances), which, for the income year 2025, is SEK150,000 per person. From 2026, the tax-free threshold will be raised to SEK300,000.

Trends and Developments

Contributed by:
Björn Wendleby, Rico Benavides, Per Josephson and Stellan Koch
Harvest Advokatbyrå AB

Harvest Advokatbyrå AB was established in 2016 and is Scandinavia's largest independent specialist law firm, with a clear focus on advising financial institutions. Its 30-lawyer-strong banking and finance team advises clients ranging from innovative start-ups, payment institutions, banks, fund managers and investment firms to crypto-asset service providers and other companies active in the Swedish financial sector. It advises on a wide range of legal and financial regulatory issues important for the finance industry, including compliance, internal audits, application procedures, AML/CTF and sustainable finance, as well as on the outsourcing of technology services by financial institutions. The firm maintains frequent and close contact with the Swedish Financial Supervisory Authority (SFSA; Finansinspektionen), and a number of its employees are SFSA alumni. The scope of its services also includes advising companies in the banking and finance sector on corporate matters, such as setting up legal entities, transactional assistance and preparing and negotiating agreements. The firm also advises on data privacy and data protection issues. Harvest's office is located in Stockholm.

Authors

Björn Wendleby is a partner at and founder of Harvest Advokatbyrå. Björn specialises in financial regulation, mainly within exchange and securities law, banking and finance legislation, asset management, crypto-assets, sustainability regulation and AML. He has represented clients in contacts with the Swedish Financial Supervisory Authority (Finansinspektionen), advising in matters relating to authorisations with the Financial Supervisory Authority and in various implementation projects. Björn has participated in several long-term projects implementing new legislation, such as MiFID/MiFID 2, PSD/PSD 2, AIFMD and 4AMLD. His client portfolio includes banks, investment firms, payment institutions, fund managers and crypto-asset service providers. Björn is ranked in band 1 in Banking & Finance (Europe) and Regulatory (Sweden) by Chambers.

Rico Benavides is a member of the Swedish Bar Association who has been working on financial regulatory compliance matters since 2014. Rico specialises in financial regulation, especially in asset management (UCITS and AIFMD), investment services (MiFID), insurance (IDD) and anti-money laundering and counter-terrorist financing (AMLD). He advises foreign and domestic companies operating in the financial industry, such as investment firms, fund managers, banks, insurance companies and insurance distributors, in matters relating to regulatory compliance with the Swedish Financial Supervisory Authority including authorisation, the implementation of new legislation, cross-border business setups and corporate and contract law matters. Several of Rico's clients are fintech companies providing robo-advice, e-commerce payments or crypto-trading services.

Per Josephson is a senior associate at Harvest Advokatbyrå. He specialises in financial regulation, especially in the areas of fund management, asset management, securities, sustainable finance and AML/CFT. In his daily work, Per provides advice on a variety of matters relating to authorisations with the SFSA and on various implementation projects, as well as corporate and contract law issues. Per has extensive experience in fund regulation, market abuse and sustainability regulation from the SFSA. Per is also a member of the board of Swesif, Sweden's sustainable investment forum, having the main responsibility with respect to Swesif's membership in Eurosif, a partnership of Europe-based national sustainable investment forums (SIFs).

Stellan Koch specialises in financial regulation, especially in the areas of asset management, securities and AML. In his daily work, Stellan advises several clients in the financial industry, such as fund managers, in matters relating to regulatory compliance. He also participates in projects implementing new legislation and with applications for authorisation with the Swedish Financial Supervisory Authority (Finansinspektionen).

Harvest Advokatbyrå AB

Engelbrektsplan 1
Box 7225
103 89 Stockholm
Sweden

Tel: +46 0820 4011
Email: info@harvestadvokat.se
Web: www.harvestadvokat.se

SWEDEN TRENDS AND DEVELOPMENTS

Contributed by: Björn Wendleby, Rico Benavides, Per Josephson and Stellan Koch, **Harvest Advokatbyrå AB**

Introduction

From the sustainable finance framework to anti-money laundering guidelines, the investment fund sector in Sweden is no exception when it comes to the increase in regulatory detail seen in the past few years. Looking beyond legislation, the sector has been developing rapidly lately, with the headline being the procurement of funds for the Swedish premium pension system.

In this trends and development chapter, attention is brought to both sectorial development and the regulatory outlook. While focusing on national trends and developments, it should be noted that the Swedish regulatory landscape for investment funds is largely derived from EU legislation and developments therein. As such, where relevant, reference will be made to developments initiated at the EU level.

This chapter focuses on three subject areas of special interest to the Swedish investment fund sector.

- Firstly, the procurement of funds for the Swedish premium pension system is a non-stop topic of discussion heavily focused on by management companies. The Swedish premium pension system is now being changed from an open market system to a system that instead is procuring funds to be made available for selection in the premium pension, giving rise to new challenges and trends.
- Secondly, two major mergers were completed in the Swedish fund market in 2024. The recent consolidations of management companies highlight the pressure related to a well-maintained asset under management (AUM) and the ability to keep refining offerings.
- Lastly, in efforts towards ensuring the Swedish fund market's competitiveness, the government has issued a committee review of the Swedish fund legislation. The committee review includes inter alia whether association-based funds with variable share capital could be the next move for the Swedish fund market.

Procurement of Funds for the Swedish Premium Pension System

Background and initial tenders

Commencing in mid-2023 and ramping up through 2024 and 2025, the Swedish Fund Selection Agency (*Fondtorgsnämnden* (FTN)) was established with the task of procuring funds to be made available in the Swedish premium pension system. The procurement is one of a kind and drastically limits the number of funds available for pension savers.

The Swedish premium pension system accounts for 2.5% of the overall general pension income. At the beginning of 2022, the premium pension system was managing approximately SEK2 trillion (EUR175 billion) and is projected to manage upwards of SEK4 trillion by 2040. Unlike the general pension system, the premium pension system allows for funds to be chosen on an individual basis. When no active choice is made, the state-managed fund AP7 Såfa is the default option.

In the wake of complex and expensive fund schemes and scandals negatively affecting the Swedish premium pension system, resulting for example in criminal sentences for gross disloyalty to principal, as seen in the case of Allra (formerly Svensk Fondservice) and Falcon Funds, new legislation was passed introducing a procedure for the procurement of funds to be made available within the system.

FTN, a governmental agency, was established with the sole purpose of procuring and providing quality assurance for funds to be made available for active selection. The procedure comprises a range of procurements, somewhat mirroring the AUM allocation over different fund types. Ramping up towards the end of 2024 and continuing into 2025, the authors see larger procurement classes being announced, among them actively managed global equity funds with a primary focus on investments in large and mid-cap companies (approximately SEK200 billion under management, with 14 funds to be procured) and actively managed Swedish equity funds with the same primary focus (approximately SEK96 billion under management, with ten funds to be procured).

Effects of procurement

A tougher environment for smaller fund companies

To qualify for the FTN procurements, there have been – among others – certain thresholds for fund company size. A highly discussed criterion has been the total AUM of SEK5 billion, effectively ruling out smaller fund companies. The frustration of the smaller fund companies camp has not been reduced by the majority of winning tenders to date being funds from larger fund companies, such as those associated with the larger Swedish banks.

The ever-increasing costs and complexity of regulatory requirements, in combination with losing out on FTN procurements, may give rise to the continued consolidation of the smaller fund company sector or a shift in business strategy towards new opportunities outside the premium pension system.

It should be noted that even when a smaller-sized fund company successfully retains its presence in the premium pension system, procurements give rise to downward price pressure on the management fees. Indeed, in procurement selection, the management fee is a factor later reflected in the distribution agreement with the Swedish Pension Agency (*Pensionsmyndighete* n). Larger fund management companies having synergies on other fronts (eg, net interest synergies within bank groups) may even intensify the price competition, effectively coming down hard on the revenue of smaller-sized fund companies with high premium pension system exposure. Thus, it can be expected that the ability to refine offerings will be key for the players in the lower AUM segment; otherwise, consolidation trends may continue.

Financial stability in relation to the shifting of procured funds within the premium pension system

Concerning the funds currently available in the premium pension system that do not submit tenders or lose out in the procurement process, the Swedish Pension Agency (the registered unit holder for the premium pension) will have to redeem its units from losing funds, shifting the assets to procured funds. There is speculation on the effects this may have, where the regulator has taken the “one buyer but also one seller” approach, not factoring in that losing and winning funds may have different portfolio exposures within the procured sector. Others have raised the alarm regarding a possible temporary “hailstorm” in the market come “shifting day”. In terms of financial market stability, the Swedish Financial Supervisory Authority (SFSA) has strongly implied that fund companies losing out in the procurement process should maintain close contact with the Swedish Pension Agency to discuss flexibility in the wind-down procedures.

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Consolidation trends

It is not only the smaller fund company segment that is seeing consolidation trends. Throughout 2024, two new giants took form. In September 2024, Öhman Fonder effectively executed the absorption of Lannebo Fonder, which, going forward, will be operating under the brand Lannebo Kapitalförvaltning, creating the largest independent fund company in the Nordics with AUM north of SEK250 billion. Just weeks later, in October 2024, Carnegie Fonder's absorption of Didner & Gerde Fonder was approved by the authorities, leading to AUM of approximately SEK185 billion for Carnegie Fonder.

To further accelerate the Carnegie "merger train", albeit not consolidating the fund operations, shortly after October 2024 it was announced that Altor Fund III and the minority shareholders in Carnegie Holding (the parent company of Carnegie Fonder) had entered into an agreement to sell Carnegie Holding to the Norwegian group DNB Bank ASA, subject to regulatory approvals expected to take place in H1 2025.

It is safe to say 2024 has seen an uptick in consolidation trends. The outcome of the FTN procurements and continued price competition may, as mentioned previously, continue to have an impact with respect to whether further consolidations are going to be seen in the sector in 2025. Further, regulatory and operational costs associated with the implementation of major new and complex regulations, such as the Digital Operational Resilience Act (DORA), may mean that fund companies remain on the lookout for cost-effective synergy opportunities throughout 2025.

The Ongoing Committee Review of Swedish Fund Legislation

Introduction and summary

In December 2023, the Swedish government decided upon a committee directive, appointing a designated investigator that shall examine – and propose the necessary legislative amendments to adapt – Swedish law in accordance with the revisions to the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for Collective Investment in Transferable Securities Directive (the "UCITS Directive"). The investigator will also assess and propose measures to enhance the competitiveness of the Swedish fund market, including regulations pertaining to association-based funds with variable share capital.

Additionally, the investigator will review the rules regarding redemption frequency and analyse how the resilience of Swedish funds and investor protection can be strengthened. The overarching goal is to modernise fund legislation, render the Swedish fund market more competitive and resilient, and ensure alignment with EU law.

Specifically, the investigator shall:

- assess the legislative amendments required to align Swedish law with the changes made to the AIFMD and the UCITS Directive;
- analyse and provide recommendations on the appropriate regulatory framework for association-based funds with variable share capital;
- analyse and determine the necessary changes to enable securities funds to be open for redemptions twice per month; and
- provide the requisite legislative proposals.

The findings of the investigation shall be submitted no later than 30 April 2025.

Alignment of Swedish law with the changes to the AIFMD and the UCITS Directive

In light of the recent amendments to the AIFMD and the UCITS Directive at the EU level, it will be necessary to review existing provisions and introduce new provisions in national legislation pertaining to inter alia liquidity management tools. As of 1 July 2023, the Swedish fund legislation incorporated provisions on the use of the liquidity tool known as "swing pricing". The amendments to the AIFMD and the UCITS Directive take the required liquidity tools one step further, introducing a range of liquidity tools that are to be implemented. The ongoing committee review is expected to propose the incorporation of the amendments, with no major deviations.

Loan originating funds

Furthermore, the AIFMD amendments introduce regulations governing loan originating funds. Swedish legislation currently lacks specific regulations governing such funds, including an investment strategy to provide credit loans – ie, procedures related to the assessment of credit risk, oversight of the credit portfolio and alignment with associated liquidity risks in terms of redemptions. The committee will, among other things, review whether Sweden should exercise options in the amended AIFMD to impose stricter leverage limits than those specified in the Directive. The implementation of the amendments themselves, and any potential gold plating, could have an impact on existing and new alternative investment funds originating loans as their investment strategy.

Association-based funds with variable share capital

The committee review is also tasked with reviewing a potential new framework for association-based funds with variable share capital, benchmarking the popular *société d'investissement à capital variable* (SICAV; investment company with variable capital) structure from Luxembourg. Acknowledging the popularity and competitiveness of the SICAV and subsequent fund establishment in Luxembourg, the committee review is tasked with evaluating similar structures for association-based funds with variable share capital, including in terms of potential tax considerations, increasing the Swedish fund market's competitiveness.

It should be noted that a Swedish framework for association-based funds with variable share capital has been under governmental review before, both in 2002 and as late as 2016. However, prior attempts have not had the same overarching mandate as that of the current committee review, raising the hopes of those wanting to see SICAV-like structures in Sweden. The result of the committee review is expected in March 2025. However, in practice, fund managers should not expect the utilisation of such constructions any time soon, as after the committee review is published, the ordinary legislate procedure – in the best-case scenario – will have to pass through preparatory stages and Parliament.

Contractual-based alternative investment funds

In terms of alternative investment funds, Swedish special funds (formally alternative investment funds derived from the AIFMD, but which adhere to most of the requirements that undertaking for collective investment in transferable securities (UCITS) funds are subject to) are considered separate from other alternative investment funds in terms of liability. A special fund, like a UCITS fund, in Sweden cannot acquire rights or hold liabilities under the Swedish UCITS Act (*Svensk författningssamling* (SFS) 2004:46) – instead, the fund company holds them in respect of the fund.

Alternative investment funds other than special funds, however, lack a similar possibility of being created on a mere contractual basis and instead are created through, for example, Swedish limited liability companies (*aktiebolag*). Under its mandate, the committee review will look more closely at the possibility of creating contractual-based alternative investment funds, other than special funds, as it is believed such a framework would make it easier to establish new funds, increasing the attractiveness of establishing European long-term investment funds (ELTIFs) in Sweden. The taxation aspect is also to be considered in this regard.

Review of certain provisions related to exchange-traded funds

Today, Swedish legislation provides the possibility of exempting UCITS funds traded on a regulated market from redemption requirements, insofar as it is ensured that the market value does not significantly deviate from the net asset value. Subsequently, the provision does not apply to units traded on a multilateral trading facility (MTF) platform. Whereas the UCITS Directive does not explicitly provide for the nature of the exchange, the committee review has been tasked with evaluating whether the exemption should also be available for MTF-traded funds.

In addition, the committee review is tasked with determining whether a certain unit class should be able to be traded on a trading venue when other unit classes are not.

New fund structures for institutional investors

Investors in a common fund in Sweden are currently not taxed for transactions within the fund, but must calculate its tax liability based on the return on the units. From a cross-border perspective, certain jurisdictions provide full exemption from taxation at the source of income (eg, dividends in portfolio companies) for certain institutional investors, such as pension schemes. A contractual fund structure where the investor is seen to invest directly in the underlying holdings may therefore allow such institutional investors to avoid taxation.

For the Swedish fund market to continue to attract foreign institutional capital, the committee review will be looking at whether Swedish legislation should allow for a fund structure that is contractually based, tax-transparent and available to institutional investors, to provide for exposure towards the underlying assets rather than the unit itself, effectively providing for lower tax where applicable.

Redemption frequency for UCITS funds

With the COVID-19 pandemic in the rear-view mirror, the SFSA has suggested that UCITS funds should be permitted to have a redemption frequency set as low as bi-weekly, allowing for a liquidity profile better aligned with a fund’s character. The suggestion is to align with the minimum requirement under the UCITS Directive rather than the current gold-plated legislation, where a minimum weekly redemption frequency applies. In addition, certain exemptions – subject to SFSA approval – will be investigated by the committee review, allowing for an up-to-monthly redemption period.

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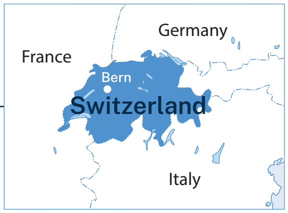

Law and Practice

Contributed by:
Nicolas Béguin, Joseph Merhai, Thomas Pasquier and Benjamin Vignieu
Aegis

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Contributed by: Nicolas Béguin, Joseph Merhai, Thomas Pasquier and Benjamin Vignieu, **Aegis**

Aegis is a highly specialised Swiss business law firm, founded in 2014. Its lawyers advise and represent domestic and international clients, mainly in banking and finance, corporate and tax matters. Clients are mostly corporate groups and financial institutions, as well as high net worth individuals and entrepreneurs.

Authors

Nicolas Béguin is a partner at Aegis. He advises and represents clients in banking, financial markets and corporate law matters, including M&A, and also acts as counsel in banking and corporate disputes. He is a member of the board of directors of the European Society for Banking and Financial Law (AEDBF Europe), and a member of the Geneva Bar Examination Commission, the Geneva Bar Civil Law Commission and the Swiss Arbitration Association (ASA). He also lectures at the CAS – Compliance in Financial Services.

Joseph Merhai is a partner at Aegis and specialises in corporate tax law, international tax planning, M&A and strategy and transfer pricing. He represents individuals and companies in tax law and tax criminal law matters. Joseph has extensive experience in banking tax law and in the taxation of investment structures (collective investment schemes and wealth structures) and commodity trading companies. He serves on the board of directors of several companies.

Thomas Pasquier specialises in all areas of Swiss and international tax law. His expertise includes providing tax advice for investment funds and businesses at all stages of their development, from incorporation and financing rounds to management buyouts, exits and restructurings. He advises entrepreneurs and private clients on all their tax matters, including relocation to Switzerland, philanthropic activities, real estate investments, business transfers and estate and succession planning. Thomas also represents clients in tax proceedings (contentious or non-contentious) before administrative authorities and courts, at both cantonal and federal levels.

Benjamin Vignieu is a senior associate at Aegis, whose practice focuses on banking, finance and corporate law. He advises banks, financial institutions, wealth management service providers and individuals on banking, finance and regulatory matters. He is also particularly active in commercial litigation, and has strong experience in corporate law and M&A.

Aegis

Rue du Général-Dufour 20
1204 Geneva
Switzerland

Tel: 022 703 5100
Email: info@aegis.ch
Web: www.aegis.ch

1. Market Overview

1.1 State of the Market

Investment funds (collective investment schemes, or CIS) established under Swiss law are strongly focused on local investors, mainly because they do not benefit from a European regulatory "passport" for distribution in the European Union. The number of Swiss CIS is therefore relatively limited compared to other jurisdictions, such as Luxembourg. Asset management, on the other hand, is very strong in Switzerland, particularly in Zurich and Geneva, and benefits from a highly competitive economic, financial and regulatory environment.

According to the latest publication of the Asset Management Association Switzerland (AMAS) dated 28 October 2024, the Swiss fund market showed strong growth in 2024, reaching a volume of CHF1.565 trillion in the third quarter. Investment returns have been the main driver of such increase. Following the recent interest rate cuts, there has been a trend reversal towards riskier asset classes as new money inflows have shifted. Finally, as noted by AMAS, the acquisition of Credit Suisse by UBS has contributed to changes in the Swiss market structure, with a further strengthening of UBS' position.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Introduction

The establishment and operation of Swiss CIS are governed by the Federal Act on Collective Investment Schemes of 23 June 2006 (CISA) and its implementing ordinances: the Ordinance on Collective Investment Schemes of 22 November 2006 (CISO) and the Ordinance of the Swiss Financial Market Supervisory Authority on Collective Investment Schemes of 27 August 2014 (CISO-FINMA). The marketing of Swiss CIS in Switzerland is regulated by the Federal Act on Financial Services of 15 June 2018 (FinSA) and its implementing ordinance: the Ordinance on Financial Services Ordinance (FinSO). Managers of collective assets and fund management companies are regulated by the Federal Act on Financial Institutions of 15 June 2018 (FinIA).

Generally speaking, Swiss CIS can be either open-ended or closed-ended (Article 7, para 2 CISA). The difference between these two forms lies in the liquidity offered to investors. Open-ended CIS give investors a direct or indirect right to redeem their units at net asset value (Article 8, para 2 and Article 78, para 2 CISA), at the expense of the collective assets. Conversely, closed-ended CIS do not give investors any direct or indirect right to redeem their units at net asset value, at the expense of the collective assets (Article 9, para 2 CISA).

Swiss alternative investment funds (AIFs) can be structured in either of these two forms, but the use of Swiss CIS for alternative funds is relatively limited in practice.

Open-Ended Funds

Swiss open-ended CIS take the form of either a contractual investment fund or an investment company with variable capital (SICAV) (Article 8, para 1 CISA).

Open-ended collective investments are further divided into different categories according to their investment policy:

- securities funds (Article 55 et seq CISA);
- real estate funds (Article 58 et seq CISA);
- other funds for traditional investments (Article 70 CISA); and
- other funds for alternative investments (Article 71 CISA).

This last category is logically the most relevant for Swiss AIF.

Contractual investment funds

Contractual investment funds are based on a contract between the investors, the fund management company and the custodian bank (Article 25 CISA). Under the terms of this contract, which is referred to as an investment fund contract, the fund management company manages the collective assets independently and in its own name.

The fund's investors participate in the fund in proportion to the units they have acquired (Article 25, para 1 CISA); the custodian bank essentially safeguards the collective assets, issues and redeems fund units and manages payment transactions (Article 73, para 1 CISA).

The fund contract must comply with certain legal requirements (Article 26, para 3 CISA and Article 35a et seq CISO) and must be submitted to the Swiss Financial Market Supervisory Authority (FINMA) for approval (Article 26, para 1 CISA).

SICAV

The SICAV is an alternative to the contractual investment fund, whose structure is based on Luxembourg SICAV legislation. Like the contractual investment fund, the SICAV is an open-ended CIS, since it allows investors to request the redemption of their units and their repayment in cash at any time (Article 78, para 2 CISA). However, unlike the contractual investment fund, the SICAV is a public limited company governed by the provisions of the Swiss Code of Obligations (CO), subject to the specific provisions of CISA.

Any person recognised by the SICAV as a shareholder may exercise voting rights, with each share in principle entitling the holder to one vote (Article 47, para 1 CISA). However, the decision to dissolve the SICAV and its sub-funds rests solely with the entrepreneur shareholders (Article 41, para 2 CISA). Investors also have a right to information (Article 84, paras 1 and 2 CISA) and may apply to the court at the registered office of the management company for the auditing company or another expert to examine the facts requiring verification and submit a report (Article 84, para 3 CISA). Lastly, investors may bring an action for restitution if assets have been misappropriated or if pecuniary benefits have been unlawfully obtained at the expense of the SICAV (Article 85 CISA).

In terms of pecuniary rights, the SICAV entitles shareholders to a share of the profits (Article 78, para 1, lit b CISA) and to a proportional share of the liquidation proceeds (Article 97, para 2 CISA). Shareholders also have the right to demand the repurchase of their shares and their redemption in cash at any time (Article 78, para 2 CISA). The redemption price is set on the basis of the net asset value per unit on the valuation date, plus or minus any commissions and costs (Article 80 CISA). Limitations on the right to redeem are also possible, as is the case with contractual investment funds.

Other funds for alternative investments

This is a category of open-ended CIS (which can be structured either as a contractual investment fund or as a SICAV), whose investments, structure, investment techniques (short-selling, borrowing of funds, etc) and investment restrictions entail a risk profile that is typical for alternative investments (Article 71, para 1 CISA).

Leverage is permitted only up to a certain percentage of the fund's net assets (Article 71, para 2 CISA). Other funds for alternative investments may:

- raise loans for an amount equal to a maximum of 50% of the net assets (Article 100, para 1, lit a CISO);
- pledge or cede as collateral no more than 100% of the fund's net assets (Article 100, para 1, lit b CISO);
- commit to an overall exposure of up to 600% of the fund's net assets (Article 100, para 1, lit c CISO); and
- engage in short-selling (Article 100, para 1, lit d CISO).

Reference must be made in the fund name and in fund documentation and advertising material to the special risks involved in alternative investments (Article 71, para 3 CISA).

Finally, FINMA may allow such funds investing directly to use a prime brokers instead of a Swiss custodian bank for settlement services (Article 71, para 5 CISA).

Closed-Ended Funds

Closed-ended CIS take the form of either a Swiss limited partnership for collective investments (LPCI) or an investment company with fixed capital (SICAF) (Article 9, para 1 CISA).

Swiss limited partnership

The LPCI is the Swiss equivalent of the limited partnership under Anglo-Saxon law (CISA Message, FF 2005 6019 f), and was designed primarily as a private equity investment vehicle (Article 103, para 1 CISA). However, the LPCI may be used to make other investments (Article 103, para 2 CISA), including alternative investments, real estate, and construction and infrastructure projects (Article 121 CISA). It is therefore a potentially adequate structure for a Swiss AIF.

The LPCI is established on the basis of the limited partnership referred to in Article 594 et seq of the CO and is supplemented by the special provisions of CISA (Article 99 CISA). It is a partnership without legal personality, which may nevertheless, under its corporate name, acquire rights and commit itself, sue and be sued (Article 99 CISA cum Article 602 CO), which gives it quasi-personality. The LPCI must secure double prior authorisation from FINMA, both as a subject (Article 13, para 2, lit c CISA) and as a product (Article 15, para 1, lit c CISA).

As an LPCI is a closed-ended CIS, investors have no direct or indirect right to the redemption of their units at the net asset value charged to the collective assets. This is justified by the investments that LPCI are required to make – ie, in principle highly illiquid investments. Introducing an unconditional redemption right for investors, as is the case for contractual investment funds and SICAVs, would jeopardise the long-term future of the LPCI and would be completely at odds with its investment objectives. A maximum term is typically for the partnership agreement (Article 102, para 1, lit e LPCC), to avoid having investors indefinitely locked into the vehicle.

An LPCI involves three parties: the promoter, the partner with unlimited liability and the limited partners.

- The promoter of the LPCI is the shareholder (direct or indirect) of the limited company (*société anonym*; *Aktiengesellschaft*) acting as a partner with unlimited liability. They will generally invest alongside the investors (Article 119, para 3 CISO).
- The unlimited partner (also named "partner with unlimited liability" or "general partner") must be incorporated as a limited company (*société anonyme Aktiengesellschaft*) under Swiss law (Article 98, para 2 CISA) and have paid-up share capital of at least CHF100,000 (Article 118, para 2 CISO). The unlimited partner is responsible for the management of the LPCI (Article 599 CO) and represents it in dealings with third parties.
- Limited partners are the investors in the LPCI. They play a passive role in the LPCI and are only liable up to a certain amount, known as the "

- *commandite*" (Article 98, para 1, phr LPCC and Article 608, para 1 CO). Given the significant risks and financial commitments inherent in investments in hedge funds and private equity, limited partners must be qualified investors within the meaning of Article 10, para 3 or 3ter of CISA (Article 98, para 3 CISA), which in turn refers to Article 4, paras 3 to 5 and Article 5, paras 1 and 4 of FinSA.

Unlike contractual investment funds and SICAVs, LPCIs are not required to engage a custodian bank due to the nature of their investments. However, an LPCI may utilise custody and payment services if the partnership agreement explicitly so provides (Article 102, para 1, lit j CISA).

The economic rights conferred by an LPCI unit are set out in the partnership agreement. However, investors in an LPCI are not limited to property rights alone. They may – and often will – have certain pecuniary obligations stipulated in the partnership agreement. These obligations may include making additional investments (capital contribution obligations) or repaying a portion of the profits in predefined circumstances (claw-backs).

The participation rights of the limited partner are limited. The limited partner does not have the right to manage the company's affairs (Article 600, para 1 CO). Moreover, they have no means of objecting to management actions that fall within the scope of the company's ordinary operations (Article 600, para 2 CO) and have only very limited rights of information and control (Article 601, para 3 CO and Article 106 CISA).

SICAF

The SICAF is a non-listed Swiss limited company within the meaning of Article 620 et seq of the CO. Its shareholders are not necessarily qualified shareholders and its sole purpose is collective investment (Article 110, para 1 CISA). The SICAF is essentially governed by the provisions relating to public limited companies (Article 112 LPCC). A share in a SICAF must be fully paid-up (Article 113, para 1 CISA).

The SICAF is authorised to make investments that:

- have only limited access to the market;
- are subject to significant price fluctuations;
- involve limited risk spreading; or
- are difficult to value (Article 69, para 2 CISA cum Article 115, para 2 CISA).

Like SICAVs, SICAFs must obtain both prior authorisation as a subject (Article 13, para 2, lit d CISA) and prior approval as a product (Article 15, para 1, lit d CISA) from FINMA.

To date, the SICAF has remained no more than a theoretical vehicle that has fallen out of favour with fund promoters, mainly for tax reasons and because of the burden of its regulatory regime.

L-QIF

Created on the basis of the Restricted Alternative Investment Funds (RAIFs) that have recently developed extensively in Luxembourg, the Limited Qualified Investor Fund (L-QIF) is a CIS that is:

- exclusively reserved for qualified investors;
- administered by certain Swiss regulated entities; and
- not subject to authorisation, approval or supervision by FINMA.

The L-QIF may be an open or closed-ended CIS. It is not a new legal form of CIS, since it can only take the form of some existing Swiss CIS – ie, a contractual investment fund, a SICAV or an LPCI (Article 118c CISA). The form of a SICAF is excluded.

In principle, the provisions of CISA apply to L-QIFs, with a number of important exceptions, including provisions governing the obligation to obtain authorisation or approval from FINMA and the obligation to be subject to FINMA supervision. L-QIFs are also not subject to the obligation to publish a prospectus.

The absence of FINMA supervision is compensated above all by the auditing of the L-QIF by an auditing company approved by FINMA on the one hand, and by the special requirements imposed on the administration of the L-QIF, which will have to be carried out by specific institutions subject to FINMA supervision (indirect supervision), on the other. In general, an L-QIF is managed by a fund management company but, depending on the type of L-QIF and legal requirements, management and investment decisions can be (sub)delegated to other regulated entities (such as a manager of collective assets or a foreign manager of collective assets).

L-QIFs benefit from a high degree of freedom in terms of investment regulations, risk diversification and permitted investments (Article 118d CISA). Such freedom enables L-QIFs to proceed to traditional investments as well as alternative ones. If an L-QIF invests in alternative investments, reference must be made to the particular risks associated with these investments in the designation, in the relevant documents (fund contract, the investment regulations or the partnership agreement) and in the advertising material. In the case of L-QIFs in the legal form of a contractual fund or SICAV, the risk notice must take the form of a warning clause that briefly and concisely describes the main risks associated with the potential investments. The warning clause must be included on the first page of the fund contract or the investment regulations and in the advertising documents.

Investment Companies Not Governed by CISA

Article 2, para 3 of CISA provides for some exceptions whereby an investment company is not governed by CISA, and in particular is not considered as a SICAF.

The first exception is an investment company in the form of a Swiss limited company (*société anonymeAktiengesellschaft*), the shares of which are listed on a Swiss exchange.

The second exception requires the fulfilment of two cumulative conditions:

- only qualified investors are shareholders of the investment company and are entitled to participate in the company; and
- the shares of the investment are registered shares.

The notion of qualified investors is important for investment companies in order to determine whether the second exception above can apply. This notion is introduced in CISA and is specifically defined by Article 10, paras 3 and 3ter to encompass four types of qualified investors:

- professional clients pursuant to Article 4, para 3 and 5 of FinSA;
- institutional clients pursuant to Article 4, para 4 of FinSA;
- retail clients who opted out in accordance with Article 5, paras 1 and 2 of FinSA; and
- retail clients with an asset management or investment advice agreement (Article 10, para 3ter CISA).

In addition, Article 2, para 2, lit a–g of CISA provide for seven types of entities that are not governed by CISA.

This is particularly the case for operating companies that are engaged in entrepreneurial activities pursuant to Article 2, para 2, lit d of CISA. For the purpose of applying CISA and irrespective of their legal status, such operating companies meet the following requirements:

- they have either their registered office as defined by their articles of association or their actual registered office in Switzerland, or are established in Switzerland if their registered office as defined by their articles of association is located in another state;
- they pursue their activities on a commercial basis or on a scale that requires commercially organised business operations; and
- their main purpose is the management of a services, production or trading business (Article 1b, para 1 CISO).

In particular, operating companies are companies that:

- develop or construct real estate;
- produce, buy, sell or exchange goods and commodities; or
- offer other services outside the financial sector (Article1b, para 2 CISO).

Another noteworthy exception is investment clubs whose members are in a position to manage their financial interests themselves (Article 2, para 2, lit f CISA). Such clubs, irrespective of their legal status, must meet four requirements:

- the membership rights are set out in the relevant constitutive document for its chosen legal status;
- the members or a section of the members take the investment decisions;
- the members are informed about the status of the investments on a regular basis; and

- the number of members does not exceed 20.

The use of this type of structure must be carefully evaluated, as it is not intended to serve as a business model.

2.1.2 Common Process for Setting Up Investment Funds

Generally speaking, Swiss CIS require authorisation from FINMA (Article 13, para 1 and Article 15, para 1 CISA). Exceptions are collective investments structured as L-QIFs (which must, however, be administered by certain institutions authorised by FINMA), and investment companies not subject to CISA.

Entities providing management and administration services to Swiss CIS also require FINMA authorisation – ie, collective investment managers and fund management companies (Article 5, para 1 FinIA).

Please see **2.3.4 Regulatory Approval Process** regarding the length of the process.

In addition to the regulator's fees, auditors' fees shall be taken into account as part of the CIS' set-up expenses.

Contractual Investment Funds

Contractual investment funds are established by an investment fund contract involving the investors, the fund management company and the custodian bank. Both the fund management company and the custodian bank must be authorised by FINMA (Article 5, para 1 FinIA and Article 13, para 2, lit e CISA).

Under the investment fund contract, the fund management company undertakes to ensure that the investors participate in the investments in proportion to their assets, and to manage the funds' assets in accordance with the fund contract at its own discretion and for its own account (Article 25, para 1 CISA). The investment fund contract must be submitted to FINMA for approval (Article 15, para 1, lit a CISA).

The FINMA fees associated with the decision on the approval of the investment fund contract are set between CHF1,000 and CHF10,000.

SICAVs and SICAFs

The establishment of SICAVs and SICAFs is primarily governed by the company law provisions outlined in the CO. However, exceptions apply to the rules on contributions in kind, acquisitions in kind and special privileges, which are specifically governed by CISA (Article 37, para 1). Their establishment requires an act of incorporation in the form of a public deed (Article 629, para 1 CO).

SICAVs and SICAFs must be authorised by FINMA as institutions (Article 13, para 2, lit b and d CISA) and submit their constituting documents (ie, articles of association and investment regulations) to FINMA for approval (Article 15, para 1, lit b and d CISA).

In the case of a SICAV requiring authorisation as an umbrella fund consisting of multiple subfunds, each sub-fund must be approved individually (Article 15, para 2 CISA).

Advance approval from FINMA is also required for any product-related changes that involve amendments to the investment regulations (Article 16 CISA and Article 14 f CISO).

The FINMA fees for obtaining authorisation as a SICAV or a SICAF range from CHF4,000 to CHF30,000. Fees for the approval of the articles of association and investment regulations are set between CHF1,000 and CHF10,000.

Swiss Limited Partnership (LPCI)

The establishment of LPCIs primarily follows the company law provisions governing ordinary limited partnerships under the CO (Article 99 CISA). The general partner must be a limited company (*société anonymeAktiengesellschaft*) with its registered office in Switzerland. General partners without authorisation as managers of collective assets may only be active as a general partner in one LPCI.

LPCIs must be authorised by FINMA as an institution (Article 13, para 2, lit c CISA) and must submit their constituting documents (ie, the partnership agreement) to FINMA for approval (Article 15, para 1, lit c CISA). Advance approval from FINMA must also be obtained for all product and licence-related changes to the basis on which authorisation was originally granted (Article 16 CISA and Article 14 f CISO).

The FINMA fees for obtaining authorisation as an LPCI range from CHF4,000 to CHF30,000. The fees for approving the partnership agreement are set between CHF1,000 and CHF10,000.

2.1.3 Limited Liability

Investors in open-ended funds are only liable up to the amount of their initial investment (see in particular Article 36, para 1, lit c CISA). For contractual investment funds and SICAVs structured as umbrella funds with multiple sub-funds, each sub-fund's liability is restricted to its own obligations, and investors in one sub-fund cannot be held liable for the liabilities of other sub-funds (Article 93, para 2 CISA).

Similar to investors in SICAVs, the liability of investors in SICAFs is legally limited to their capital contributions.

In the case of a closed-ended LPCI, the unlimited partner bears unlimited liability, while the limited partners are liable only up to their contribution (Article 98, para 1 CISA). Investors in an LPCI may – and very often will – have certain pecuniary obligations set out in the partnership agreement. These include the obligation to make additional investments (capital contribution obligation) or the obligation to repay a share of the profits in predefined cases (claw-backs).

2.1.4 Disclosure Requirements

Duty to Publish a Prospectus

Rules pertaining to product documentation are essentially governed by FinSA and FinSO.

Fund management companies of contractual investment funds, SICAVs, LPCIs and SICAFs must issue and publish a prospectus when offering to the public (Article 48, para 1 FinSA).

The prospectus of contractual investment funds, SICAVs and SICAFs shall be submitted to FINMA (Article 48, para 4 FinSA) and must provide detailed information about the funds' establishment, legal structure and operational framework (such as information about its duration, tax provisions, accounting year and the name of its audit company). In addition, the prospectus must outline the investment strategy, permitted investments and investment restrictions. It must disclose information about compensation, costs and fees and the accessibility to relevant documents such as fund contracts and reports. It is also mandatory to include information on the licensee, custodian bank and third-party providers, as well as the historical performance of the fund (see Annex 6 of FinSO).

LPCI prospectuses must contain the information in the partnership agreement on investments, investment policy, investment restrictions, risk diversification, risks associated with investment and investment techniques (Article 49, para 2 FinSA).

L-QIFs are not required to produce a prospectus (Article 50, para 1 FinSA).

Duty to publish a Key Information Document (KID)

Funds that are offered to retail investors outside the scope of a portfolio management agreement must issue a KID (Article 58, para 1 FinSA). This basic information sheet must contain all the information essential for investors to make a well-founded investment decision and a comparison of different financial instruments (Article 60, para 1 FinSA).

Foreign AIFs

Foreign AIFs offered in Switzerland to non-qualified investors, high net worth retail clients and private investment structures created for them that have opted out of being treated as professional clients must include information on the Swiss representative and paying agent in their prospectus (Article 133, para 2 CISO). It shall also include information on the location where the prospectus, the KID, the constituting documents of the funds, and the last annual and semi-annual reports may be obtained (Article 133, para 2 CISO).

Reporting Requirements

Open-ended funds and LPCIs are required to publish an annual report within four months of the close of the financial year, providing the following information in particular (Article 89, para 1 and Article 108 CISA):

- the annual accounts consisting notably of a statement of net assets or the balance sheet and the profit and loss account;
- the number of units redeemed and newly issued during the financial year;
- the inventory of the fund’s assets;
- the valuation principles;
- a breakdown of the buy and sell transactions;
- the names of persons and companies to which duties have been entrusted; and
- other information relating to matters of particular economic or legal significance, such as amendments to funds regulations, a change of fund management company or custodian bank and legal disputes.

SICAFs are also required to publish a similar annual report, but with limited information tailored to this type of fund (Articles 89 and 117 CISA).

Open-ended funds and closed-ended funds must also publish a semi-annual report, which shall be issued within two months after the end of the first half of the financial year (Article 89, para 3 and Articles 108 and 117 CISA). This report notably contains an unaudited financial statement, information on units issued and redeemed during that period, the inventory of the fund’s assets and a breakdown of the buy and sell transactions.

Similar reporting requirements apply to foreign AIFs (Article 133, para 2, lit d CISO).

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Swiss CIS, including Swiss AIFs, are strongly focused on local investors, mainly because they do not benefit from a European regulatory “passport” for distribution in the European Union.

According to the Asset Management Study 2024 published by AMAS, pension funds represent the largest client segment. Other common types of investors in AIFs in Switzerland include institutional investors such as insurance companies, private banks and other financial intermediaries, which often invest on behalf of their clients both in Switzerland and abroad. High net worth individuals and their family offices also represent a significant portion of investors in Switzerland, investing either directly or through financial intermediaries.

Swiss regulations limit access to AIFs for retail investors, as these products are predominantly reserved for qualified investors.

2.2.2 Legal Structures Used by Fund Managers

Please see **2.1.1 Fund Structures** for detailed information on Swiss legal structures used by fund managers.

2.2.3 Restrictions on Investors

In theory, open-ended funds and SICAFs are open to all investors (Article 10, para 2 CISA). In practice, many open-ended AIFs focus exclusively on qualified investors, particularly when seeking exemptions from specific provisions of CISA from FINMA (see notably Article 10, para 5 CISA).

Only qualified investors are permitted to invest in LPCIs and L-QIFs (Article 98, para 3 and Article 118a, para 1, lit a CISA).

CISA distinguishes between qualified and non-qualified investors (also referred to as retail clients). The following investors are deemed to be qualified investors (Article 10, para 3 and 3ter CISA):

- supervised financial intermediaries, which include in particular banks, central banks, securities firms, fund management companies, managers of collective assets, portfolio managers, CIS and foreign financial intermediaries subject to similar prudential supervision;
- supervised insurance companies and foreign insurance companies subject to similar prudential supervision;
- public entities, institutions and foundations with professional treasury operations, occupational pension schemes with professional treasury operations, companies with professional treasury operations, large companies and private investment structures with professional treasury operations created for high net worth retail clients;
- high net worth retail clients and their private investment structures that have opted to be treated as professional clients under FinSA; and
- retail clients to whom a financial intermediary provides portfolio management or investment advice in accordance with FinSA within the scope of a permanent portfolio management or investment advisory relationship.

Clients that are not listed as qualified investors are considered to be non-qualified investors.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Regarding open-ended funds, the investment limitations of AIFs depend on the classification of the funds.

“Other funds for alternative investments” offer the broadest range of investments and strategies. Such funds are permitted to invest notably in securities, precious metals, real estate, commodities, derivatives, units of other collective investment schemes, money market instruments and sight and time deposits with a term of up to 12 months (Article 69 CISA and Article 99 CISO). They may carry out investments that:

- have only limited marketability;
- are subject to strong price fluctuations;
- exhibit limited risk diversification; and
- are difficult to value (Article 69, para 2 CISA).

Such funds are characterised by investments, structure, investment techniques (short-selling, borrowing of funds, etc) and investment restrictions that exhibit a risk profile that is typical for alternative investments (Article 71, para 1 CISA).

LPCIs can invest in risk capital, construction, real estate, infrastructure projects, alternative investments, other investments and a mixed form of those investments (Articles 120 and 121 CISO).

SICAFs may invest in the same asset classes authorised for other funds for alternative investments (Article 115, para 2 CISA).

For other types of funds, please see **3.3.1 Regulatory Regime**.

2.3.2 Requirements for Non-Local Service Providers

Fund management companies, SICAVs, LPCIs, SICAFs and managers of collective assets of Swiss AIFs must apply for authorisation with FINMA and are subject to its prudential supervision (Article 5, para 1 FinIA and Article 13, para 2 CISA). Only Swiss banks authorised by FINMA can act as custodian bank of a Swiss AIF (Article 72, para 1 CISA).

Swiss AIFs shall have their head office and effective place of management in Switzerland. Tasks may be delegated solely to third parties that possess the necessary skills, knowledge and experience, and that have the required authorisations (Article 14, para 1 FinIA). FINMA may subject the delegation of investment decisions to an asset manager located abroad to an agreement on co-operation and information exchange between FINMA and the competent foreign supervisory authority, particularly if such an agreement is required under the other country's legislation (Article 14, para 2 FinIA).

2.3.3 Local Regulatory Requirements for Non-Local Managers

As Swiss AIFs must have their head office and effective place of management in Switzerland (see **2.3.2 Requirements for Non-Local Service Providers**), non-Swiss domiciled managers cannot manage AIFs domiciled in Switzerland.

Please see **2.3.2 Requirements for Non-Local Service Providers** regarding the delegation of investment decisions.

2.3.4 Regulatory Approval Process

The authorisation and approval process generally involves a preliminary discussion with FINMA, followed by a formal application. FINMA aims to grant approval within two months from the date it receives a complete filing (see notably Article 17 CISO). The duration of the process depends on the complexity of the fund, its investment strategy and the investors targeted. In practice, however, the regulatory approval process may take longer, often exceeding six months.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

If the pre-marketing activity is aimed at acquisition or disposal, or takes the form of the provision of personal recommendations on transactions relating to units in AIFs, it triggers the application of the requirements set forth under FinSA (see **2.3.6 Rules Concerning Marketing of Alternative Funds**).

2.3.6 Rules Concerning Marketing of Alternative Funds

Swiss AIFs

The marketing of Swiss AIFs in Switzerland is regulated by FinSA and its implementing ordinance. Marketing of AIFs to investors in Switzerland does not require a FINMA licence but may be considered as a financial service under FinSA. As a result, it may trigger Swiss regulations on financial service provision, which include:

- rules of conduct at the point of sale (eg, duty to inform, assessment of appropriateness and suitability of financial services, documentation and accountability);
- organisational requirements; and
- for financial service providers targeting non-qualified investors, an affiliation with an ombudsman's office.

In addition, client advisers of Swiss financial service providers not subject to supervision, as well as client advisers of foreign financial service providers, may carry out their activity in Switzerland only if they are entered in a register of advisers (Article 28, para 1 FinSO). Prudentially supervised client advisers of foreign financial service providers are exempt from the registration requirement if they provide their services only to qualified investors (Article 28 FinSA and Article 31 FinSO).

Furthermore, offering fund units to the public triggers the obligation to publish a prospectus (see **2.1.4 Disclosure Requirements**).

Foreign AIFs

Foreign CIS, including foreign AIFs, must be approved by FINMA before they can be offered to non-qualified investors in Switzerland (Article 120, para 1 CISA), although their number is very limited in practice. Accordingly, foreign AIFs may be offered to qualified investors in Switzerland without regulatory approval or authorisation. If foreign AIFs are offered to non-qualified investors and/or qualified investors that are high net worth retail clients (including the private investment structures created for them), a Swiss representative and paying agent must be appointed (Article 120, para 4 CISA).

In addition, the marketing of foreign AIFs must comply with the requirements applicable to the marketing of Swiss AIFs.

2.3.7 Marketing of Alternative Funds

Please see **2.2.3 Restrictions on Investors** for a detailed overview of the categories of investors to which AIFs can be marketed in Switzerland.

2.3.8 Marketing Authorisation/Notification Process

No authorisation or notification is required by FINMA prior to the marketing of Swiss AIFs. However, foreign AIFs must be approved by FINMA before they can be offered to non-qualified investors in Switzerland (Article 120, para 1 CISA).

2.3.9 Post-Marketing Ongoing Requirements

There are no post-marketing ongoing requirements for financial services providers that have marketed an AIF in Switzerland.

For foreign CIS, please see **2.3.6 Rules Concerning Marketing of Alternative Funds** regarding the duty to appoint a Swiss representative and paying agent.

2.3.10 Investor Protection Rules

In Switzerland, investor protection provisions are an integral part of the regulatory framework for AIFs. Specific restrictions apply to ensure that certain categories of investors are specifically safeguarded. In practice, Swiss and foreign AIFs are generally only available to qualified investors. Non-qualified investors are typically restricted from investing in AIFs, in order to minimise exposure to high-risk investment products.

Swiss law imposes additional requirements when a fund is authorised for offering to non-qualified investors, such as the obligation to issue a KID or, for foreign AIFs, the requirement to be approved by FINMA (Article 120, para 1 CISA). In addition, foreign AIFs that are offered to non-qualified investors and/or qualified investors that are high net worth retail clients (including the private investment structures created for them) must appoint a Swiss representative and paying agent (Article 120, para 4 CISA).

2.3.11 Approach of the Regulator

In Switzerland, FINMA adopts a co-operative approach to regulation. In particular, FINMA requires all supervised persons and entities to fully co-operate by providing any information and documents necessary for FINMA to effectively perform its regulatory duties (Article 29, para 1 of the Financial Market Supervision Act of 22 June 2007 (FINMASA)). Supervised persons and entities must also report to FINMA any incident that is of substantial importance to the supervision (Article29, para 2 FINMASA). The authority is also open to discussing regulatory issues on an informal basis and issuing rulings to provide clarity and guidance on regulatory matters.

2.4 Operational Requirements

Open-ended AIFs and SICAFs must appoint a custodian bank (Article 25, para 2 and Articles 44a and 114 CISA). Only a Swiss bank licensed under the Swiss Banking Act can be appointed in such capacity (Article 72, para 1 CISA). The custodian bank shall have an appropriate organisational structure to act as custodian bank, and is notably responsible for the safekeeping of the investment fund's assets, the issue and redemption of units, and payment transfers on behalf of the AIF (Article 73 CISA).

Unlike the other categories of funds, LPCIs are not required to use a custodian bank, given the nature of the investments made. However, LPCIs may use a custody service and a payment service, provided that the partnership agreement so provides (Article 102, para 1, lit j CISA).

2.5 Fund Finance

Subject to specific regulatory restrictions, AIFs may take out loans and grant securities over the fund's assets to support their investment strategies. The CISO prescribes leverage limits as a percentage of the fund's net assets, varying based on the type of AIF. "Open-ended CIS for alternative investments" may:

- raise loans for an amount of up to 50% of the fund's net assets;
- pledge or transfer as collateral no more than 100% of the fund's net assets;
- commit to an overall exposure of up to 600% of the fund's net assets; and
- engage in short-selling (Article 100, para 2 CISO).

Please see **3.5 Fund Finance** for the restrictions applicable to the other type of funds.

The investment restrictions shall be set out explicitly in the fund regulations, which shall indicate the nature and scale of short-selling permitted (Article 100, para 3 CISO).

LPCIs are not subject to any particular restrictions on borrowing.

2.6 Tax Regime

Swiss and foreign CIS may be either tax transparent or opaque, depending on their form and features.

Swiss contractual investment funds, SICAVs and LPCIs are tax transparent, and their income is directly attributed to the investors (and not to the fund, subject to certain requirements). As an exception, funds that directly hold real estate are tax liable.

SICAFs and non-regulated companies are not tax transparent, meaning that the company is itself tax liable (in addition to shareholders for their income).

A foreign CIS may be recognised as tax transparent from a Swiss perspective if the following conditions are met:

- the distribution of its units in Switzerland has been approved by FINMA;
- it is supervised by a recognised supervisory authority; or
- the investment fund's purpose is to offer opportunities for collective investment.

Swiss tax authorities apply several criteria to assess this last condition.

Swiss CIS are subject to Swiss withholding tax for their net income. Swiss-based investors may typically claim it back. Non-Swiss-based investors may potentially be exempt, subject to certain conditions. Certain criteria (ensuring in particular an effective management out of Switzerland) must be met in order for foreign CIS to not be subject to Swiss withholding tax.

Finally, a Swiss stamp duty applies to the transfer of securities, including units of investment funds, if a Swiss securities dealer is involved (among other conditions). The notion of "Swiss securities dealers" notably includes Swiss banks.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

Retail funds are structured as open-ended CIS and may be established as either a contractual investment fund or SICAV. Based on their investment policy, these funds are classified as securities funds, real estate funds or other funds for traditional investments.

While SICAFs are permitted for retail funds, no such vehicles have been registered in Switzerland since the introduction of CISA in 2007.

The LPCI and L-QIF are not available to retail investors (Article 98, para 3 and Article 118a, para 1, lit a CISA).

For further information on the fund structures available in Switzerland, please see **2.1.1 Fund Structures**.

3.1.2 Common Process for Setting Up Investment Funds

Please see **2.1.2 Common Process for Setting Up Investment Funds** for details on the process involved in setting up open-ended CIS and SICAFs, which are available to retail investors.

3.1.3 Limited Liability

Investors in open-ended funds are liable only up to the amount of their investment (see in particular Article 36, para 1, lit c CISA). For contractual investment funds and SICAVs structured as umbrella funds with multiple sub-funds, each sub-fund's liability is restricted to its own obligations, and investors in one sub-fund cannot be held liable for the liabilities of other sub-funds (Article 93, para 2 CISA).

Similar to investors in SICAVs, the liability of investors in SICAFs is legally limited to their capital contributions.

3.1.4 Disclosure Requirements

Please see **2.1.4 Disclosure Requirements**, which applies to both AIF and retails funds.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

As Swiss CIS do not benefit from a European regulatory "passport" for distribution in the European Union, Swiss retail funds typically target Swiss domiciled non-qualified investors.

3.2.2 Legal Structures Used by Fund Managers

Please see **3.1.1 Fund Structures** for detailed information on the Swiss legal structures used by retail fund managers.

3.2.3 Restrictions on Investors

Approved Swiss retail open-ended CIS, approved SICAFs and approved foreign CIS can be marketed to any type of investor, including non-qualified investors.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

Investment limitations depend on the classification of the open-ended funds (securities funds, real estate funds or other funds for traditional investments).

Securities funds may invest their assets in securities, derivative financial instruments, units in collective investment schemes, money market instruments, sight or time deposits with a term to maturity not exceeding 12 months and other investments, provided that it does not exceed 10% of the fund's total assets (Article 54 CISA and Article 70 CISO). However, investment in precious metals, precious metal certificates, commodities or commodity certificates is prohibited, and short selling is not permitted (Art 70, para 2 CISO).

Real estate funds may invest in residential buildings, properties that are used exclusively or mainly for commercial purposes, mixed-use buildings used for residential as well as commercial purposes, condominiums, building land (including properties for demolition), buildings under construction and leasehold land (Article 59 CISA and Article 56 CISO). Other investments are also permitted, such as mortgage notes or other contractual charges on property, participations in claims against real estate companies, units in other real estate funds, and foreign real estate securities (Article 86, para 3 CISO).

Other funds for traditional investments provide a broader range of investments and strategies. Such funds are notably permitted to invest in securities, precious metals, real estate, commodities, derivatives, units of other collective investment schemes, money market instruments and sight and time deposits with a term of up to 12 months (Article 69 CISA and Article 99 CISO). They may carry out investments that have only limited marketability, that are subject to strong price fluctuations, that exhibit limited risk diversification and that are difficult to value (Article 69, para 2 CISA). Such funds include open-ended CIS, which in terms of their investments, investment techniques and investment restrictions entail a risk profile that is typical for traditional investments (Article 70, para 1 CISA).

SICAFs may invest in the same asset classes authorised for other funds for traditional investments (Article 115, para 2 CISA).

3.3.2 Requirements for Non-Local Service Providers

Please see **2.3.2 Requirements for Non-Local Service Providers**, which also applies to retail funds.

3.3.3 Local Regulatory Requirements for Non-Local Managers

Please see **2.3.3 Local Regulatory Requirements for Non-Local Managers**, which also applies to retail funds.

3.3.4 Regulatory Approval Process

Please see **2.3.4 Regulatory Approval Process**, which also applies to retail funds.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Please see **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**, which also applies to retail funds.

3.3.6 Rules Concerning Marketing of Retail Funds

Please see **2.3.6 Rules Concerning Marketing of Alternative Funds**, which also applies to retail funds.

3.3.7 Marketing of Retail Funds

In theory, all Swiss CIS (except LPCIs and L-QIFs) can be marketed to all investors (qualified and non-qualified investors). In practice, Swiss CIS limit themselves to qualified investors, notably when they seek exemptions from certain provisions of CISA from FINMA (Article 10, para 5 CISA).

Foreign CIS must be approved by FINMA before they can be offered to non-qualified investors in Switzerland (Article 120, para 1 CISA).

3.3.8 Marketing Authorisation/Notification Process

No authorisation or notification is required by FINMA prior to the marketing of Swiss CIS. However, foreign CIS must be approved by FINMA before they can be offered to non-qualified investors in Switzerland (Article 120, para 1 CISA).

3.3.9 Post-Marketing Ongoing Requirements

There are no post-marketing ongoing requirements for financial services providers that have marketed a CIS in Switzerland.

For foreign CIS, please see **2.3.6 Rules Concerning Marketing of Alternative Funds** regarding the duty to appoint a Swiss representative and paying agent.

3.3.10 Investor Protection Rules

Please **2.3.10 Investor Protection Rules**, which also applies to retail funds.

3.3.11 Approach of the Regulator

Please see **2.3.11 Approach of the Regulator**, which also applies to retail funds.

3.4 Operational Requirements

Please see **2.4 Operational Requirements**, which also applies to retail funds.

3.5 Fund Finance

Subject to specific regulatory restrictions, retail funds may take out loans and grant securities over the fund's assets to support their investment strategies. The CISO prescribes leverage limits as a percentage of the fund's net assets, varying based on the type of CIS, as outlined below.

- Open-ended CIS classified as securities funds may borrow the equivalent of up to 10% of the fund's net asset, but limited to a temporary basis. In addition, such funds may only pledge or transfer as collateral up to a maximum of 25% of the fund's net assets (Article 77, paras 1 and 2 CISO).
- Open-ended CIS for traditional investments may raise loans for an amount of up to 25% of the fund's net assets, pledge or assign as collateral no more than 60% of the fund's net assets, commit to an overall exposure of up to 225% of the fund's net asset and engage in short-selling (Article 100, para 1 CISO).
- Open-ended CIS specialising in real estate are required to maintain an adequate proportion of the fund's assets in short-term fixed-interest securities or in funds available at short notice to order to secure their liabilities (Article 60 CISA). Short-term fixed-interest securities are deemed to be debt securities with a term or residual term to maturity of up to 12 months (Article 89 CISO). Funds available at short notice are cash positions or bank account deposits at sight and on demand with maturities of up to 12 months, as well as guaranteed credit facilities with a bank for up to 10% of the fund's net assets (Article 89, para 3 CISO). The credit facilities must be included in the maximum level of encumbrance permitted by law, meaning that the encumbrance may not exceed on average one-third of the market value of all real estate assets of the fund (Article 89, para 3 CISO).

3.6 Tax Regime

Please see **2.6 Tax Regime**.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Revision of CISA and CISO

In March 2024, the revised CISA and its implementing ordinance (CISO) came into force. A key aspect of the revised CISA is the introduction of the long-awaited L-QIF, which allows the launch of CIS for qualified investors under certain conditions. Other provisions of CISA and CISO, not directly related to L-QIFs, have also been amended.

L-QIFs are operated without the approval, authorisation or product supervision of FINMA. To be eligible, these funds must be offered solely to qualified investors and managed by entities that are supervised by FINMA, typically a fund management company. To ensure transparency, the fund must be clearly labelled as a Limited Qualified Investor Fund on the front page of the fund documents and in any promotional materials.

Self-Regulation on Transparency and Disclosure

The revised AMAS "Self-regulation on transparency and disclosure for sustainability-related collective assets" came into effect on 1 September 2024 and aims to ensure transparency, quality and the positioning of asset management and collective assets with a focus on sustainability. While the guidelines are binding for AMAS members, they are not yet recognised or approved as self-regulation by FINMA. The self-regulation provides binding organisational, reporting and disclosure obligations for institutions that produce and manage sustainable financial products. These regulations reflect the Federal Council's position on greenwashing prevention in the financial sector, issued on 16 December 2022.

Trends and Developments

Contributed by:
Joseph Merhai and Thomas Pasquier
Aegis

Aegis is a highly specialised Swiss business law firm, founded in 2014. Its lawyers advise and represent domestic and international clients, mainly in banking and finance, corporate and tax matters. Clients are mostly corporate groups and financial institutions, as well as high net worth individuals and entrepreneurs.

Authors

Joseph Merhai is a partner at Aegis and specialises in corporate tax law, international tax planning, M&A and strategy and transfer pricing. He represents individuals and companies in tax law and tax criminal law matters. Joseph has extensive experience in banking tax law and in the taxation of investment structures (collective investment schemes and wealth structures) and commodity trading companies. He serves on the board of directors of several companies.

Thomas Pasquier specialises in all areas of Swiss and international tax law. His expertise includes providing tax advice for investment funds and businesses at all stages of their development, from incorporation and financing rounds to management buyouts, exits and restructurings. He advises entrepreneurs and private clients on all their tax matters, including relocation to Switzerland, philanthropic activities, real estate investments, business transfers and estate and succession planning. Thomas also represents clients in tax proceedings (contentious or non-contentious) before administrative authorities and courts, at both cantonal and federal levels.

Aegis

Rue du Général-Dufour 20
1204 Geneva
Switzerland

Tel: 022 703 5100
Email: info@aegis.ch
Web: www.aegis.ch

aegis

Contributed by: Joseph Merhai and Thomas Pasquier, **Aegis**

Investment Funds in Switzerland: An Introduction

Asset management firms such as BlackRock, KKR and Family offices are increasingly focusing on private markets to diversify and enhance returns. Private equity firms are also targeting high net worth individuals by creating funds with lower minimum investments and more retail-friendly structures. Firms like EQT and Coller Capital have developed such offerings, while fintech platforms like iCapital and Moonfare facilitate high net worth individuals' access to private markets.

There is a growing focus on investments that generate positive environmental, social and governance (ESG) impacts alongside financial returns. The Global Impact Investing Network values this market at over USD1.57 trillion globally, reflecting rapid growth and acceptance among investors. However, challenges persist, including misconceptions about ESG performance assessment and the need for standardised impact measurement frameworks.

The demand for artificial intelligence (AI) capabilities is driving a wave of mergers and acquisitions worldwide but Switzerland has not seen such restructuring yet, notably because of the relatively small size of companies active in that sector in Switzerland.

It should also be noted that vehicles active in the art market are increasing in appeal for retail investors and seem to be having increasing success with high net worth individuals wishing to diversify outside the securities and real estate market.

The state of the Swiss investment fund industry

The Swiss investment fund industry is in a dynamic state of evolution, shaped by ongoing regulatory developments and slowly shifting tax policies that influence both domestic and international actors. With Switzerland's reputation as a global financial hub, these developments are crucial for investors, asset managers and other stakeholders who aim to navigate the complexities of compliance while leveraging opportunities. The key regulatory shifts and tax implications that are shaping the landscape are presented below.

From a regulatory standpoint, the Swiss investment fund industry has witnessed substantial transformations over the past few years, primarily driven by global trends towards transparency, investor protection and alignment with international standards.

The Financial Services Act (FinSA) and the Financial Institutions Act (FinIA), both enacted in 2020, continue to impact fund distribution and governance in significant ways. These legislative measures were introduced to ensure that Switzerland remains aligned with European Union regulations, such as MiFID II, which emphasise investor protection and market integrity.

The Swiss Financial Market Supervisory Authority (FINMA) has also played a crucial role in adapting the regulatory framework, focusing on the digitalisation of financial services and the growth of sustainable finance – a key trend that is influencing how funds are structured, marketed and managed.

FinSA and FinIA further enhance the regulatory landscape by introducing uniform rules for financial service providers, including investment fund managers. FinSA sets out requirements for client segmentation, information duties and suitability assessments, ensuring that investors receive appropriate advice and transparent information regarding investment products. FinIA, on the other hand, establishes the licensing requirements for financial institutions, including fund managers, and defines the organisational standards they must meet. Together, these acts create a cohesive regulatory environment that promotes investor protection and aligns Swiss regulations with international best practices.

The Collective Investment Schemes Act (CISA) sets out the rules for the authorisation, organisation and operation of collective investment schemes. Along with its implementing ordinances, CISA provides a robust legal basis for the functioning of both open-ended and closed-ended funds, specifying requirements for fund managers, custodians and distributors.

Under CISA, fund managers must adhere to stricter governance and risk management requirements, including provisions related to the safekeeping of assets, valuation procedures and transparency in investor communications. These regulations are intended to safeguard the interests of investors and ensure that fund operations are conducted in a prudent and professional manner, and have been further developed by case law and clarification from FINMA.

The scope of CISA and its dynamic relationship with FinSA and FinIA have also been clarified during the last couple of years, providing more clarity for the market as a whole and the asset management community.

In addition, the introduction in 2023 of the Limited Qualified Investor Fund (L-QIF) represented a significant development in the Swiss fund industry. L-QIFs are designed to provide a more flexible, cost-effective vehicle for qualified investors, enabling swift and efficient fund set-up without prior FINMA approval. This move not only demonstrates Switzerland's commitment to enhancing its competitiveness in the global fund market but also highlights its responsiveness to the needs of sophisticated investors who seek greater agility and reduced regulatory burdens. The L-QIF was expected to attract more private and institutional investors, and thus strengthen the position of Switzerland as a favourable domicile for alternative investment funds, but its adoption has been slow. It seems that the costs and oversight by a regulated bank, asset management company or fund administrator are deemed burdensome, and some modifications would be welcome.

Another notable regulatory trend is the increasing focus on sustainable finance. Switzerland has committed to creating a supportive regulatory environment for sustainable investments, in line with global efforts to combat climate change and promote responsible investing. In this context, FINMA has introduced guidelines on the transparency and disclosure of sustainability-related risks for financial institutions, including investment funds.

This regulatory emphasis on sustainability is encouraging fund managers to integrate ESG criteria into their investment strategies, thereby aligning with investor demand for more responsible and impact-focused investment products. The trend towards sustainable finance is not only reshaping the types of funds available in the market but is also influencing reporting standards and the expectations placed on asset managers.

The Swiss regulatory landscape is also adapting to the rise of digital assets and blockchain technology. FINMA has issued guidelines to clarify the regulatory treatment of blockchain-based financial instruments, including tokenised funds. The rise of digital assets presents both opportunities and challenges for the investment fund industry, as managers explore the potential for tokenising traditional assets to improve liquidity and reduce costs.

Switzerland's progressive stance on blockchain regulation, including the adoption of the Distributed Ledger Technology (DLT) Act, positions it as a leader in the development of a regulatory framework that supports innovation while ensuring investor protection. This regulatory clarity is expected to attract more fintech companies and fund managers interested in exploring digital asset opportunities.

Marketing of investment funds in Switzerland

The marketing of investment funds in Switzerland is subject to a well-defined still quite new regulatory framework aimed at protecting investors and ensuring the integrity of the financial market.

FinSA plays a central role in regulating how investment funds are marketed within Switzerland. It introduced new rules for client segmentation, differentiating between private clients, professional clients and institutional clients. This segmentation is crucial for determining the level of information and protection afforded to investors and the specific requirements that fund marketers must meet.

Under FinSA, fund distributors must provide clients with a basic information document known as the Key Information Document (KID) for retail clients, which contains essential information about the investment product, including its risks and costs. The aim is to enhance transparency and help investors make informed decisions. In addition, marketing materials must be clear, accurate and not misleading, and they must comply with the disclosure requirements set forth by FINMA to ensure the consistency and reliability of the information provided to potential investors.

Marketing requirements are less stringent for qualified investors, such as high net worth individuals and institutional clients compared to retail clients. The introduction of the L-QIF has also impacted the marketing landscape, as L-QIFs can be marketed exclusively to qualified investors without prior FINMA approval, offering a streamlined and efficient approach to reaching sophisticated investors.

Cross-border marketing of investment funds into Switzerland is another area governed by strict regulations. Foreign funds that wish to be marketed in Switzerland must appoint a Swiss representative and a paying agent, and they must comply with the provisions of CISA. FINMA approval is required for funds that are to be distributed to non-qualified investors, ensuring that foreign funds meet the same standards of investor protection as domestic funds.

The rise of digital platforms has also influenced the marketing of investment funds, with an increasing number of fund managers leveraging digital tools to reach a broader audience. However, the use of digital marketing is subject to the same regulatory standards as traditional marketing, and fund managers must ensure that online promotions comply with Swiss regulations, including data protection laws and requirements for providing accurate and non-misleading information.

Overall, the regulatory framework for marketing investment funds in Switzerland is designed to promote transparency, protect investors and ensure fair competition in the financial market.

Investment funds and taxation

From a tax perspective, Switzerland continues to balance the need for competitiveness with the demands for greater tax transparency and alignment with international tax standards. Recent efforts by the Swiss government to reform corporate tax, particularly with the Federal Act on Tax Reform and AHV Financing (TRAF), have implications for the fund industry. These reforms aim to ensure that Switzerland remains attractive to multinational entities by lowering the effective tax rates while also eliminating preferential tax regimes that were previously criticised by international bodies such as the OECD. For investment funds, the evolving tax landscape impacts decisions on fund domicile, structuring and the treatment of income and capital gains, all of which are key considerations for both fund managers and investors.

Another significant aspect of the tax developments is Switzerland's commitment to the OECD's Base Erosion and Profit Shifting (BEPS) initiatives, which influence how investment funds navigate cross-border tax planning. The increasing emphasis on substance requirements and transparency has led to more rigorous scrutiny of fund structures, particularly those that rely on favourable tax treaties. As a result, fund managers are adapting by ensuring that their Swiss entities demonstrate sufficient substance and operational presence to meet international standards, thereby avoiding challenges related to treaty benefits or transfer pricing issues.

Moreover, Switzerland's participation in the Automatic Exchange of Information (AEOI) framework has introduced new compliance requirements for fund managers, impacting the way information is shared with tax authorities globally. The AEOI regime, which aims to combat tax evasion by ensuring that financial account information is exchanged between jurisdictions, has necessitated significant adjustments in reporting processes for Swiss funds. These changes have increased the administrative burden on fund managers, who must ensure that they are fully compliant with both Swiss and international reporting standards, while also maintaining the confidentiality and trust that Switzerland is known for in the financial sector.

Overall, the Swiss investment fund sector is navigating a period of considerable change, driven by tax compliance updates that align with global standards and tax reforms that enhance competitiveness while ensuring compliance with international obligations. These trends are shaping the strategic decisions of fund managers, who must adapt to new regulatory requirements, leverage opportunities presented by new fund vehicles like L-QIF and navigate an increasingly complex tax environment.

The ongoing developments in the legal and tax landscape are not only reshaping the operational framework of investment funds in Switzerland but also influencing investor behaviour and the attractiveness of Switzerland as a fund domicile in the global context.

Despite considerable efforts, Switzerland remains a challenging jurisdiction for establishing an investment fund, particularly when the fund's portfolio includes significant Swiss assets, as regulatory and tax hurdles continue to limit the attractiveness of Switzerland as a domicile for such funds. The tax compliance framework in Switzerland is stringent, with complex requirements and high costs associated with fund registration and operation. In addition, the tax treatment of Swiss-based funds can be less favourable compared to other jurisdictions, which further diminishes its appeal as a fund domicile. As a result, most fund promoters tend to prefer jurisdictions such as Luxembourg or Ireland, which offer more streamlined regulatory processes and greater tax efficiency.

However, for closed-end funds that primarily and durably invest in non-Swiss assets, the appeal of Switzerland increases dramatically. In these cases, the regulatory barriers are less pronounced, and the tax implications can be more manageable, particularly if the fund is structured in a way that takes advantage of Switzerland's network of double taxation treaties. Despite these potential advantages, Switzerland is still not the optimal choice for domiciling funds when compared to other more favourable jurisdictions that provide more straightforward and cost-effective solutions.

Taxation of fund advisory and fund management firms

On the other hand, Switzerland is highly regarded as a location for incorporating fund advisory and management firms. The country offers an appropriate regulatory environment, a favourable tax regime for corporate entities, and access to skilled professionals with deep expertise in the financial sector. Switzerland's reputation for financial stability, strong investor protection and high-quality infrastructure makes it an attractive hub for fund management activities. The presence of a well-established financial ecosystem, including leading banks, law firms and service providers, further enhances its attractiveness for fund advisory and management firms.

The country also benefits from a highly educated workforce, with many professionals having significant experience in the financial and asset management industries. This concentration of talent, along with Switzerland's high quality of life and political stability, makes it an ideal base for fund management and advisory firms wishing to serve both domestic and international clients.

Conclusion

While Switzerland may not be the most favourable jurisdiction for establishing investment funds, it is increasingly standing out as an excellent location for incorporating and operating fund advisory and management firms. The combination of a supportive regulatory environment, favourable tax treatment for corporate entities and access to top-tier financial expertise makes Switzerland a prime choice for the advisory and management side of the fund industry, even if the funds themselves are better domiciled elsewhere.

UK

The United Kingdom
Ireland
London
Germany
Belgium
France

Law and Practice

Contributed by:
Sam Kay, Philippa List, Mark Stapleton and Nicolas Kokkinos
Dechert LLP

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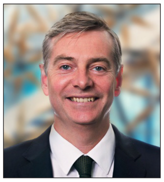
Dechert LLP is a global law firm with 17 locations across the US, Europe, the Middle East and Asia. It has one of the largest investment fund practices in the world, with a record of innovation stretching back 40 years. It advises across the full range of mainstream and alternative asset classes and strategies, representing some of the world's largest fund complexes. The asset management practice has dedicated lawyers across 15 offices and operates as a single practice group across the globe, with no internal barriers to collaboration. Clients look to the team for support across the entire fund lifecycle, from development and formation to marketing, operations and transactions. It provides advice related to fund management and governance, and assists with the full range of regulatory and compliance issues, as well as investigations and litigation involving regulatory entities around the world.

Authors

Sam Kay is a partner in Dechert's financial services group. He advises on a wide range of investment funds matters, with a particular focus on fund formation, representing private funds and asset managers throughout the private equity, private debt/credit, infrastructure and real estate industries. Sam advises GPs on complex transactions such as continuation funds, tender offers and strip sales, and has extensive experience in advising clients on matters of strategic significance, such as GP-stake sales, internal restructurings for succession planning, management spin-outs and complex carried interest arrangements. He also advises institutional investors, funds-of-funds and asset allocators on their participation in funds, as well as LP-led secondary activity from single assets to large portfolio sales.

Philippa List is a professional support counsel for Dechert's financial services practice group, and advises on EU and UK legal and regulatory developments and trends. She sits on various EU and UK industry working groups, including in relation to AIFMD reform, sustainability and ESG matters, and post-Brexit regulatory change. Philippa is actively involved in driving the practice group's AIFMD 2.0, sustainability and ESG and ELTIF 2.0 initiatives. She is also a member of Dechert's digital asset working group and was actively involved in the LIBOR and Brexit taskforces.



Mark Stapleton is a partner in Dechert's global tax group, and advises on UK and international direct and indirect taxation issues. He has extensive experience in advising offshore funds and the investment management sector, particularly global and international private credit/hybrid debt funds and hedge funds. He provides structuring and tax advice in relation to CLOs, and advises on acquisitions of public and private companies, real estate acquisitions, securitisations, structured finance and other banking, financial and corporate transactions. Mark is experienced in advising on structuring and establishing international holding companies and financing companies used in connection with inward investment transactions, cross-border acquisitions and corporate migrations.

Nicolas Kokkinos is a senior associate in Dechert's global tax group. He advises clients on direct and indirect taxation matters in the areas of corporate M&A (with a focus on private equity), financial services and investment funds, securitisation and employee incentivisation and share schemes.

Dechert LLP

25 Cannon Street
London
EC4M 5UB
United Kingdom

Tel: +44 207 184 7667
Fax: +44 207 184 700
Web: www.dechert.com

Dechert LLP

1. Market Overview

1.1 State of the Market

The UK is regarded as one of the leading global asset management centres, with an investment funds industry covering both traditional and alternative asset classes. Due to having considerable experience and infrastructure, the UK is one of the most prominent jurisdictions for fund formations and has developed a sophisticated market, offering a range of both closed-ended and open-ended types of funds. The asset management industry is of vital importance to the UK's economy.

Within the UK market, alternative investment funds (AIFs) – as defined in the EU Alternative Investment Fund Managers Directive (AIFMD) and replicated in the UK's post-Brexit alternative investment fund manager (AIFM) legislation (UK AIFM Regime) – include private closed-ended funds, often structured as English or Scottish limited partnerships, which are commonly used for funds that focus on illiquid asset strategies (eg, private equity, venture capital, real estate, alternative credit and infrastructure funds). Listed closed-ended funds available for sale to the general public are also common, and are used for both liquid and illiquid asset strategies. The vehicles most often used are investment trust companies (ITCs) and, in the case of funds that intend to invest in real estate, real estate investment trusts (REITs).

Retail funds tend to be open-ended vehicles, which can be – from a regulatory perspective – either an undertaking for collective investment in transferable securities (UCITS) fund or a non-UCITS retail scheme (NURS). One of the key advantages of a UCITS fund is that it can be marketed to investors throughout the EU without the need for additional, local authorisation in each country, known as the UCITS marketing passport. Following Brexit, UK UCITS can no longer make use of this passport. A NURS provides a similar level of investor protection to that of a UCITS and allows the manager more flexibility in terms of the investments the fund can make.

In addition to the UCITS and NURS, there is also a more lightly regulated regime for institutional and certain other qualified investors: the qualified investor scheme (QIS).

The UK provides for a large number of open-ended vehicles that fall within these two categories, including authorised unit trusts (AUTs), open-ended investment companies (OEICs) and authorised contractual schemes (ACSs). Different authorisations apply, depending on the investments to be made. For example, OEICs that invest in real estate may be structured as property authorised investment funds (PAIFs), provided the relevant conditions are met, and OEICs that invest in unauthorised funds need to be authorised as funds of alternative investment funds (FAIFs).

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Private Funds

The typical structure of a UK private equity or venture capital fund is most commonly an English limited partnership, which is a form of partnership governed by the Limited Partnerships Act 1907 (LP Act 1907). Under the LP Act 1907, English limited partnerships must have at least one general partner (GP), who is responsible for the management of the limited partnership, and one or more limited partners. Thus, investors in such funds are limited partners in the partnership. One of the fundamental attractions in the UK of a limited partnership structure for private closed-ended funds is that the limited partnership is a flexible vehicle in terms of internal governance and control.

In recognition of the importance of the private closed-ended funds business to the UK finance sector, the government introduced important reforms to the UK limited partnership law applicable to private funds, which took effect in 2017. The reforms introduced the concept of a "private fund limited partnership" (PFLP) – an English limited partnership with certain modifications, so as to simplify the regime, making it a more attractive and competitive choice of vehicle. Most private equity and venture capital funds (and related vehicles, such as co-investment vehicles and feeder funds) will fulfil the relevant PFLP conditions and can therefore choose to be designated as a PFLP (although it is not mandatory to do so).

It is also possible for a private closed-ended fund in the UK to be structured as a unit trust scheme. The English law concept of a trust has no equivalent in some other jurisdictions. It is a structure under which title to the fund's assets is held by a person with legal personality (the trustee) for the benefit of the fund's investors (the beneficiaries). The document constituting the trust (the trust deed) governs the relationship between the trustee and the beneficiaries, and strict fiduciary duties are owed by the trustee as a matter of law. A trust does not have a separate legal personality; all legal relationships are entered into by or on behalf of the trustee. These vehicles have historically most commonly been used for certain UK real estate fund structures.

In November 2021, rules came into effect for a new UK fund structure: the Long-Term Assets Fund (LTAF). The LTAF is a UK-authorised fund that is designed to be focused on long-term, illiquid assets and is particularly targeted at increasing defined contribution pension scheme investment into alternative assets.

The LTAF is an authorised fund so can be structured as an open-ended investment company (investment company with variable capital – ICVC), unit trust or contractual scheme. At the time of writing, the use of LTAFs remains limited, with just 24 registered, but the number in existence is steadily increasing, including for new asset classes (the first LTAF with a dedicated private debt strategy was launched in June 2024).

It would also be common for a UK-based private fund manager to establish its private closed-ended fund as an offshore vehicle (whether a partnership, a unit trust or a corporate entity). However, for the purposes of the description of closed-ended private funds in this chapter, the focus will be on English limited partnerships.

Listed Funds

The vehicles used most often are ITCs and REITs, which are typically structured as public limited companies under UK companies legislation and listed on a recognised stock exchange, most commonly the Premium Segment or the Specialist Funds Segment of the Main Market of the London Stock Exchange, although certain other stock exchanges both in and outside of the UK are possible.

As public limited companies, ITCs and REITs have a board of directors who are responsible for managing their affairs, and typically delegate the day-to-day operation of the investment trust. For example, investment management functions are usually delegated to a fund management company, a depositary/custodian will be appointed to be responsible for the safekeeping of the company's assets, a registrar will be responsible for the share register, and a broker will advise on the listing of the company's shares. The fund manager, depositary/custodian and broker will usually be authorised and regulated by the Financial Conduct Authority (FCA).

2.1.2 Common Process for Setting Up Investment Funds

Private Funds

The statutory framework in the UK requires an English limited partnership to be registered as such. This entails providing an application for registration to the (public) Registrar for Limited Partnerships (held at Companies House), providing certain details including the name of each limited partner and the amount of capital contributed by each limited partner. This will be conclusive evidence that an English limited partnership came into existence on the date of registration. Any changes to these details during the continuance of the English limited partnership must be similarly registered within seven days of the relevant change.

The key document for private closed-ended funds is the limited partnership agreement, which is a freely negotiated contract, with very few provisions prescribed by law, and is not available publicly. All parties will heavily negotiate the agreement prior to its execution.

Other frequently used key fund documentation includes side letters (providing certain investors with specific terms required for their specific circumstances), the subscription agreement for investors to subscribe for a commitment and be admitted as a partner in the limited partnership, and the investment management agreement for the fund to appoint the manager.

Listed Funds

An ITC is typically a UK public limited company that has been approved by His Majesty's Revenue & Customs (HMRC) as an ITC for the purposes of the relevant tax legislation. ITCs are subject to special tax rules (discussed below). Similarly, a REIT is typically a UK public limited company that has been approved by HMRC as a REIT for the purposes of the relevant tax legislation. REITs are also subject to special tax rules (discussed below). Since April 2022, it has been possible to have an unlisted REIT where, broadly, it is at least 70% owned by institutional investors. This makes the REIT a potentially attractive private fund vehicle for the right investor base.

A key consideration when setting up an ITC or REIT is that the eligibility conditions (and, post-launch, the ongoing requirements) set out in the relevant tax legislation need to be met in order to gain the tax advantages enjoyed by such vehicles. Tax lawyers should be engaged early in the process to advise on the steps a company needs to take to meet these requirements. Offers in respect of ITCs and REITs are subject to the obligation to publish a prospectus under the domestic legislation deriving from the EU Prospectus Regulation. Where a prospectus is required, this will need to be approved in an EEA member state for use in the EEA, in addition to being approved by the FCA for use in the UK. The other key document produced will be the investment management agreement for the fund to appoint the manager.

2.1.3 Limited Liability

Private Funds

The liability of a general partner for the debts and obligations of a partnership is unlimited, whereas the liability of the limited partner is limited to the amount of capital it contributes to that partnership. Also, unless the partnership is a PFLP, there is a restriction on the ability of limited partners to withdraw capital during the life of the partnership. To keep the capital element as small as possible, limited partners will typically split their commitments into a loan element (typically 99.99% of total commitments) and a capital contribution element (typically 0.01% of total commitments).

Listed Funds

In respect of ITCs and REITs, UK companies legislation limits the liability of the shareholders for company debts to the capital originally invested in the fund.

2.1.4 Disclosure Requirements

Private Funds

Although not required by UK law, the key marketing document that is usually used for a closed-ended private fund is a private placement memorandum (PPM). UK law generally requires that any marketing material, including a PPM, is “clear, fair and not misleading”. Depending on the intended recipient, the PPM may also need to be approved by an FCA-authorised person. Under the UK AIFM Regime, there are also specific requirements to make set disclosures to investors prior to their investment into the fund. These disclosures are usually included in the PPM.

Listed Funds

In addition to the UK AIFM Regime disclosure requirements, ITCs and REITs must also comply with the disclosure requirements set out in the FCA’s listing, prospectus, disclosure guidance and transparency rules.

Under UK companies legislation and the FCA’s listing, disclosure guidance and transparency rules, UK incorporated ITCs must also publish annual and semi-annual reports and accounts. The annual report and accounts must be prepared in accordance with the applicable accounting standards, and must give a true and fair view of the assets, liabilities, financial position and profit and loss of the company. The semi-annual financial reports do not need to be audited, but it is common practice to ask the auditor to cast an eye over them, and the audit committee of the fund should certainly review them.

Under the UK’s Packaged Retail and Insurance-based Investment Products (PRIIPs) Regime, derived from the EU PRIIPs Regulation, a short, standardised disclosure document containing the key information about the product being offered (a key information document, or KID) must also be produced and published for investment products marketed to retail investors in the UK. If an investment product will also be marketed to retail investors in the EU, a separate KID prepared in accordance with the EU PRIIPs Regulation must also be produced and published. Since 1 January 2023, changes to both the UK and EU regimes have led to divergence. In the UK the PRIIPs regime will be replaced by a new retail disclosure framework for ‘Consumer Composite Investments’ (CCIs), with the CCI regime covering similar products to PRIIPs. In November 2024, HM Treasury’s new regulations granting the FCA powers to construct and deliver the new CCI framework entered into force. The FCA is to set out detailed rules and guidelines for the CCI regime, which will only take effect once the UK PRIIPS regime has been repealed.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Private Funds

Investors typically seen investing in private closed-ended funds in the current market include pension funds, sovereign wealth funds, endowments, insurance companies, fund of funds and high net worth individuals.

Listed Funds

Closed-ended listed funds can be marketed broadly and attract both institutional and individual investors.

2.2.2 Legal Structures Used by Fund Managers

Private Funds

Limited liability partnerships (LLPs) tend be the most commonly used legal entity for the management entities of private equity and venture capital funds, which are attracted by some of the benefits of the LLP structure, such as flexibility and the fact they are transparent for direct tax purposes and can benefit from National Insurance contribution savings.

Listed Funds

The legal structure used for the management entity of listed alternative funds will depend on the jurisdiction in which the manager is based. The most common structure seen is a corporate vehicle.

2.2.3 Restrictions on Investors

Other than general marketing/financial promotion rules in the UK, there are no restrictions under UK legislation on the type of parties that can invest in a fund. However, in practice, REITs seek to prevent certain corporate investors from holding interests of 10% or more due to the adverse tax consequences that would otherwise arise.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Both open and closed-ended funds in the UK will almost certainly be AIFs for the purposes of the UK AIFM Regime. As such, the AIF's manager will be an AIFM and will need to be authorised to carry out AIF management in respect of that vehicle. Any person who carries on the activity of managing an AIF in the UK without being duly authorised, and in the absence of an exemption, commits an offence. In addition, if they have entered into an agreement with another person (eg, an investor) in the course of that activity, this agreement is unenforceable against that other party, who is entitled to receive their money back, and to compensation for any loss.

An ITC or REIT could be self-managed or managed by an external manager. The board of an externally managed ITC/REIT will generally consist of non-executive directors, the majority of whom must be independent of the investment manager. In many cases, ITCs and REITs now have no manager representative on the board, due to the unpopularity of such arrangement with investors.

2.3.2 Requirements for Non-Local Service Providers

The UK AIFM Regime sets out various provisions relating to service providers, such as depositaries and valuers. Neither the UK AIFM Regime nor any other UK legislation restricts the use of non-UK service providers to provide these services.

However, one restriction does apply in the UK in respect of external valuers: UK legislation prohibits an external valuer from delegating valuation to a third party.

Under the AIFMD, the depositary of an AIF must be established in the home member state of that

AIF. Therefore, EU AIFs are no longer able to use UK banks as depositories post-Brexit, and UK AIFs are no longer able to use EU banks as depositaries.

2.3.3 Local Regulatory Requirements for Non-Local Managers

FCA authorisation is always required to manage a UK AIF, irrespective of the location of the manager.

2.3.4 Regulatory Approval Process

Any firm applying for authorisation or registration by the FCA must have its head office in the UK. Although the FCA will judge each application on a case-by-case basis, the key issue in identifying the head office of a firm is the location of its central management and control.

Three types of licence are available to an AIFM that has its head office in the UK:

- authorisation under the Financial Services and Markets Act 2000 as amended (FSMA) as a full-scope UK AIFM;
- authorisation under the FSMA as a small authorised UK AIFM; and
- registration as a small registered UK AIFM.

The type of licence that is available to the manager will depend on the total amount of assets it has under management and the nature of the AIFs managed.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

The UK has not introduced equivalent legislation to that set out in the EU's Directive and Regulation on the cross-border distribution of collective investment undertakings. Although there is no formal concept of pre-marketing, any invitation or inducement to engage in investment activity will constitute a financial promotion for the purposes of the UK domestic regime. Any activity that would involve pre-marketing will therefore involve the issuance of a financial promotion in the UK, and will accordingly be restricted by the UK's financial promotion regime.

A number of useful exemptions to the restrictions on making a financial promotion are available under the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the FPO), including the following in particular:

- the "investment professionals" exemption, which permits financial promotions to be made to, inter alia, firms authorised by the FCA and any person whose ordinary activities involve carrying out the activity to which the communication relates; and
- the "high net worth entities" exemption, which permits marketing to certain categories of high net worth institutions.

Between them, these exemptions generally allow financial promotions to be made in the institutional markets.

2.3.6 Rules Concerning Marketing of Alternative Funds

The activity of marketing or promoting securities or other investments is not in itself a regulated activity requiring any form of licence in the UK. However, there are circumstances where someone whose main aim is to make promotions either for their own purposes or on behalf of others (or to help others to make promotions) may, in conjunction with the marketing or promotion, be engaged in regulated activities. In this regard, the most likely regulated activities under the Regulated Activities Order are those of "arranging deals in investments" or "advising on investments". A firm will require authorisation, with specific permission for the relevant activity, to the extent that it is deemed to carry on such activities in the UK.

2.3.7 Marketing of Alternative Funds

In practice, marketing activities in relation to a fund will also often involve the regulated activities of making arrangements with a view to another person buying or subscribing for interests in the fund. In view of this, fund marketing activities in the UK are generally conducted by authorised persons. Any person conducting marketing activities in relation to a fund should consider whether authorisation is required and, if it is authorised, whether it has the appropriate permissions from the FCA to undertake these activities.

The promotion of an interest in an unregulated collective investment scheme (such as a limited partnership interest) is restricted in the UK. Such a scheme cannot be promoted to the general public and, even for a private placement, there are broad restrictions on its promotion to different categories of recipients. The persons to which a limited partnership interest can be promoted include:

- investment professional organisations;
- high net worth organisations; and
- in limited circumstances, some certified high net worth individuals and sophisticated individuals.

In the UK, the FCA permits the marketing of a private fund to a wider group of recipients than the category of "professional investors" referred to in the AIFMD if the financial promotion rules referred to above are complied with throughout the entire marketing process.

2.3.8 Marketing Authorisation/Notification Process

Under the UK's national private placement regime (NPPR) for AIFs, the following notification requirements need to be satisfied:

- the AIFM must submit a notification to the FCA using the FCA's online system, Connect; and
- appropriate pre-investment disclosures need to be made in accordance with the provisions of the UK AIFM Regime.

There is a fee for AIFMs making a notification. Marketing can commence once the FCA has received the notification.

2.3.9 Post-Marketing Ongoing Requirements

Non-UK AIFMs marketing in the UK under the NPPR must report transparency information to the FCA using the Gabriel system.

2.3.10 Investor Protection Rules

The two main investor categories in relation to the distribution of funds in the UK are "professional investors" and "retail investors".

A "professional investor" is one who is considered to be a "professional client" (ie, a "per se professional client" or an "elective professional client", in each case within the meaning of MiFID). An investor will be a "per se professional client" if it fulfils one of a number of objective criteria listed in MiFID. Such entities include regulated financial entities, large undertakings, governments and public bodies, and investors whose main activity is to invest in financial instruments.

Any investor that does not satisfy any of the "per se" criteria in MiFID will be categorised as a "retail client", unless it can be treated as an "elective professional client". To be able to do this, the manager must assess the expertise, experience and knowledge of the investor and whether this makes them capable of making their own investment decisions and understanding the risks involved (the "qualitative test"). The investor must further pass the "quantitative test", meaning that they have satisfied two out of the three following requirements:

- having carried out transactions of a significant size on the relevant market at an average frequency of ten per quarter over the previous four quarters;
- having a financial instrument portfolio exceeding EUR500,000; and
- working or having worked in the financial sector for at least one year in a professional position.

An investor satisfying the relevant qualitative and quantitative tests and wishing to opt-up must be given a clear written warning of the protections and investor compensation rights they may lose, and they must state in writing that they are aware of the consequences of losing these protections and wish to be treated as a "professional client".

Private open and closed-ended funds tend only to be marketed to non-retail investors. Listed closed-ended funds are available to both professional and retail investors.

2.3.11 Approach of the Regulator

The FCA is regarded as being co-operative, and regularly publishes guidance on relevant regulatory matters.

2.4 Operational Requirements

An FCA-authorised manager must comply with the applicable FCA rules, which have been supplemented by the requirements of the UK AIFM Regime. A key requirement is that the manager must maintain a minimum amount of capital. Other requirements applicable to the typical manager in this structure include:

- prudential requirements, including relating to its governance, the remuneration of key staff, and internal systems and controls;
- FCA approvals of personnel in key positions;
- requirements relating to the conduct of the manager's business, including relating to disclosures to investors and the regulator; and
- anti-money laundering checks, including due diligence checks on new investors.

The FCA-authorised manager must comply with the rules set out above and, to the extent that the UK AIFM Regime applies, must also ensure that certain requirements are met by the fund, such as:

- the appointment of a depositary to have custody of certain assets and/or verify title to privately held assets;
- adherence to organisational controls (relating to risk management, compliance and valuation, for example) and conduct of business rules (relating to due diligence, execution of orders and reporting, for example); and
- compliance with rules relating to companies in which the fund has a substantial stake.

2.5 Fund Finance

The fund finance market in the UK is sophisticated and well developed, particularly for closed-ended private funds. The market includes a range of lenders, from banks to specialist debt funds, which offer finance solutions to funds and their GPs/managers. The most common product is a capital call facility, allowing the fund to draw money from the lender in anticipation of making a capital call from the fund's investors. The main advantage of this type of facility is that it will allow quick and efficient access to capital.

The fund documents (eg, the limited partnership agreement) will normally require at least ten business days' notice to be given to the investors prior to the date of any capital call, whereas the lender under a capital call facility will allow the money to be drawn on shorter notice. This type of arrangement therefore gives the GP/manager greater certainty of funding, particularly when the fund needs capital for investment purposes. It also allows the GP/manager to smooth out when capital calls are made to investors because the fund is able to make use of the facility for irregular cash requirements, such as fees and expenses.

Other types of fund finance have been developed in addition to capital call facilities, including:

- net asset value (NAV) facilities secured on the underlying assets of the fund;
- fund finance arrangements to unlock liquidity for investors; and
- facilities targeted at GPs/managers to assist team members to participate in any "GP commitment" requirements.

Despite the developments in the market, the general principle for closed-ended private funds in the UK is that investors will not want the fund to be leveraged. This is particularly the case for a private equity fund because the investment strategy of the fund itself normally includes leveraged buyouts, so investors will not want a double layer of leverage (ie, at both the fund level and the investment level). Therefore, the limited partnership agreement in a closed-ended private fund will normally impose restrictions on the amount of leverage that may be incurred by the fund (for example, the lower of 20% of commitments made by investors or the amount of uncalled commitments), and any borrowing incurred must be on a "short-term" basis.

Furthermore, under the AIFMD, any fund that incurs leverage (short-term borrowing is excluded for these purposes) is subject to additional disclosure requirements, and the AIFM is required to observe a higher degree of regulation. As a consequence, it is important for common forms of fund finance (eg, capital call facilities) to adhere to both the investor-imposed and regulatory-imposed requirements.

It would be usual for the lender of a capital call facility to take some form of security. A common approach would be for the lender to have the right to require the GP/manager to drawdown from investors to pay any outstanding indebtedness under the facility. It is even possible for the lender to step into the shoes of the GP/manager and issue drawdown notices directly to the investors. For this to be possible, the lender must be assigned the right to issue these drawdown notices under the limited partnership agreement of the closed-ended private fund.

This can give rise to negotiation with investors as to whether they are required to counter-sign security documents. A possible compromise is that the investor signs an acknowledgment that the right to drawdown has been assigned to the lender without the investor being a direct party to the security arrangements. An additional issue is whether the fund or investors are required to provide information to lenders. As a general rule, investors will not want to provide non-public information.

2.6 Tax Regime

General

Different tax regimes apply to the different forms of UK investment fund. These are complex, and a detailed summary of them is beyond the scope of this chapter, but a high-level overview of some of the key direct tax features of common UK fund structures (at both fund and investor level) is set out here for AIFs and under **3.6 Tax Regime**. Please note that the features described are necessarily general and may not apply in certain cases – eg, depending on the assets held by the fund or the circumstances of particular investors.

As a general point, the tax structuring preference of an investor will depend on its particular identity and the asset class or classes in which the fund invests. Many funds will have a wide mix of different types of investors (eg, UK resident corporates – such as life assurance companies – and individuals, sovereign wealth funds and pension funds). Fund managers will then usually look to structure the fund so as to be tax efficient for the investor base as a whole rather than a particular investor or class of investor (unless, of course, a particular investor or class is especially important or has been specifically targeted).

A key issue for all investors will typically be tax neutrality when investing through a fund (wherever that fund is established) – ie, they will not want that investment to leave them in a worse tax position than they would be in if they directly held the underlying assets instead. Investors will also commonly not want to be subject to tax filing obligations in new jurisdictions solely because of their investment in the fund, or, if that is not possible, they will commonly want to be made aware of the relevant filing obligations by the fund manager. Another factor for investors when investing in funds (wherever the funds are located) is a wish to minimise withholding taxes on their returns from the fund, due, if nothing else, to the administrative and cashflow cost.

From a UK tax perspective, a further important issue will be whether the fund would be considered to be trading. This can be relevant at both fund and investor level, as the tax privileges for certain UK fund types and investor classes do not extend to trading profits (eg, UK-registered pension schemes are generally exempt from tax on their investment income and capital profits but this exemption does not apply to trading profits). This can have an impact on the chosen structure. Similar concerns can arise for investors in other jurisdictions.

Private Closed-Ended Funds Structured as English Limited Partnerships

Tax position of the fund and investors

As mentioned in **2.1.1 Fund Structures**, the typical structure of a UK private equity or venture capital fund is the English limited partnership. These are transparent for UK direct tax purposes, which means that each limited partner is subject to tax on the income and gains allocated to it under the limited partnership agreement (whether they are distributed or not), rather than the limited partnership itself being taxable on its income and gains.

The taxation of investors on their share of the limited partnership's income and gains depends on the nature of the underlying return that the partnership has received (eg, capital gain, interest, rent or dividend) and the investor's own tax status.

English limited partnerships typically make payments to limited partners in the form of repayment of the loan element of the limited partners' partnership contribution and distribution of partnership profits. No UK withholding taxes should apply to such payments.

Listed Closed-Ended Funds – ITCs

Tax position of the fund

Companies with ITC status are subject to UK corporation tax, but (if certain conditions are met) are exempt from tax on capital gains and on profits of a capital nature from their derivative contracts and their creditor loan relationships. ITCs are also able to benefit from an elective interest streaming regime, which allows them to treat certain dividends to investors as interest distributions, enabling the ITC to claim a corporation tax deduction in respect of the interest distribution (if certain conditions are met). As a UK company, an ITC can also potentially benefit from the general UK company exemption from tax on dividends and other distributions received.

No withholding tax should apply to dividends paid to investors by ITCs, including interest distributions if the ITC enters into the elective interest streaming regime mentioned above.

Tax position of the investor

Investors in an ITC will be taxed on distributions (other than interest distributions) from an ITC in the same way as dividends from normal companies. Therefore, UK tax resident individuals will be subject to income tax, at rates of up to 39.35%, and corporation taxpayers can potentially benefit from the general UK company exemption from tax on dividends.

Interest distributions are, broadly, treated as interest receipts, so UK resident individuals will be subject to income tax (at rates of up to 45%), and corporation taxpayers will treat such distributions as if they were interest receipts under a loan relationship under the corporate loan relationship rules.

Listed Closed-Ended Funds – REITs

Tax position of the fund

A REIT is tax opaque but, if certain conditions are met, benefits from an exemption from UK tax on profits and gains from its property rental business (PRB). Conditions with which a REIT must comply include that, broadly, at least 75% of its profits must come from its PRB, at least 75% of the total value of its assets must relate to its PRB, and it must distribute at least 90% of its PRB income within 12 months of the end of the accounting period in which it arose. There is no requirement for a REIT to distribute capital gains. Other detailed REIT conditions apply in the tax legislation, which also need to be considered.

Distributions by REITs in respect of the profits and gains of their PRB are known as property income distributions (PIDs) and should be paid subject to withholding tax at the basic rate (20%), unless an exemption applies (eg, if the REIT has a reasonable belief that the person beneficially entitled to the payment is a company that is resident in the UK for corporation tax purposes).

REITs are subject to corporation tax in the usual way on any non-PRB profits (eg, trading profits). These can be paid out as dividends, without withholding tax.

Tax position of the investor

For corporation tax and income taxpayers, PIDs are generally treated as UK property income (ie, they are not treated as normal company distributions), so UK resident individuals are subject to income tax on them (at rates of up to 45%), and credit should be given for any tax withheld on payment of the PID by the REIT. Corporation taxpayers will treat them as taxable income. Depending on its particular circumstances, a non-resident investor may be able to reclaim under a double tax treaty all or part of any tax withheld from PIDs paid to it.

Other distributions of profits by REITs are taxed as dividends in the normal way. Therefore, UK tax resident individuals will be subject to income tax at rates of up to 39.35%, and corporation taxpayers can potentially benefit from the general UK company exemption from tax on dividends.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

An OEIC can be used for an open-ended retail fund, which is a collective investment scheme structured as a corporate vehicle. Different authorisations apply, depending upon the investments to be made. For example, OEICs that invest in real estate may be structured as PAIFs, provided the relevant conditions are met.

For an open-ended structure, an AUT can also be used. This is a type of unit trust authorised by the FCA, which is constituted by a trust deed made between the trustee and the manager of the fund. The property of the AUT is legally held by the trustee but managed by the manager. The investors have beneficial ownership of the property of the fund. Many PAIFs have an AUT as a feeder vehicle to enable corporate investors wishing to hold 10% or more indirectly to invest without infringing regulatory requirements.

In 2013, two new types of tax transparent funds (ACSs) were introduced in the UK. These new types of authorised funds can take the form of a partnership or a co-ownership scheme. In practice, the co-ownership scheme has proved more popular, particularly from a tax perspective. However, ACSs are only suitable for use by institutional investors, with investment restricted either to investments of a minimum of GBP1 million or to professional institutional investors.

3.1.2 Common Process for Setting Up Investment Funds

Retail funds structured as open-ended funds require prior regulatory authorisation. Open-ended funds have their own constitutional documentation, depending on which type of vehicle is being set up, as follows:

- a trust deed in the case of an AUT;
- an instrument of incorporation in the case of an OEIC; and
- a co-ownership or partnership deed in the case of an ACS.

In each case, the documents set out the features, powers and rules governing each authorised fund. There are very detailed operational requirements for both UCITS and NURS funds, however structured. Day-to-day operations are detailed in the fund's prospectus.

3.1.3 Limited Liability

OEICs in the UK can be structured as a single fund or as an umbrella company with multiple sub-funds, each of which would have its own investment aims and objectives. The legal framework in the UK provides for the ring-fencing of the assets and liabilities of each sub-fund.

An AUT can have a single fund or an umbrella fund structure. In the latter case, each sub-fund is constituted under a separate trust.

3.1.4 Disclosure Requirements

Certain pre-investment disclosures must be made to investors. Under UK regulation, every manager is required to provide comprehensive information to help investors make a balanced and informed decision about any retail fund prior to investing. In most cases, this information is contained within the prospectus. Investors in open-ended funds must have access to an up-to-date prospectus at all times.

In addition, for a UCITS, a KID must be prepared and made available to potential investors under the UCITS Directive (the UCITS KID). The UCITS KID requirements differ from those for the document that has to be produced under the PRIIPs Regulation. For example, the UCITS KID must be provided to all potential investors, not just those in the EEA; it must also be provided to both potential retail and professional investors, whereas the PRIIPs KID is only required to be made available to retail investors.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

Open-ended funds, particularly OEICs, are popular with individual investors, insurance companies and pension funds. ACSs are increasingly popular for institutional investments and pension funds.

The new open-ended fund vehicle introduced in the UK in 2021 – the LTAF (see **2.1.1 Fund Structures**) – is primarily aimed at defined contribution pension schemes, but is also available to retail clients if they are sophisticated investors or certified high net worth individuals. Since 3 July 2023, a unit in an LTAF has been categorised as a Restricted Mass Market Instrument and may be distributed to a wider market, including retail investors.

3.2.2 Legal Structures Used by Fund Managers

The legal structure used for the management entity of retail funds varies and will depend on a number of factors, such as tax considerations. The most common structure used is a corporate vehicle.

3.2.3 Restrictions on Investors

Other than general marketing/financial promotion rules in the UK, there are generally no restrictions under UK legislation on the type of parties that can invest in a retail fund. However, PAIFs cannot have a corporate investor with an interest of 10% or more (but see **3.1.1 Fund Structures** in relation to the use of feeder vehicles to address this issue).

3.3 Regulatory Environment

3.3.1 Regulatory Regime

The manager of a UCITS or other authorised fund must be authorised by the FCA to carry out this role.

3.3.2 Requirements for Non-Local Service Providers

Each open-ended fund must also have a depositary. In the UK, this is a regulated activity for which the depositary must hold the appropriate FCA permissions.

The UK's authorised fund governance regime goes further than is required under the UCITS Directive in that it places a number of additional responsibilities upon depositaries and requires them to be independent (so as to avoid and manage any potential conflicts of interest).

Depositaries in the UK are also required to undertake a wide variety of oversight activities, and are subject to extensive conduct of business rules and other regulatory requirements.

3.3.3 Local Regulatory Requirements for Non-Local Managers

FCA authorisation is always required to manage a UK authorised fund, irrespective of the location of the manager. UK rules permit a UK authorised fund manager to delegate to an overseas sub-manager, subject to certain requirements being met.

3.3.4 Regulatory Approval Process

Investment funds must be authorised or recognised by the FCA in order to be promoted to retail investors in the UK. Authorised funds must be established in the UK and take one of the following legal forms:

- ACS;
- AUT; or
- ICVC.

A fund must also be classified, based on a marketing strategy, as either a UCITS, NURS, QIS or LTAF. The application must include the requisite application form, certain relevant supporting documents and information, and an application fee. Application processing times depend on whether the application relates to a NURS or QIS (six months, although the FCA aims to process such applications within two months and one month respectively), a UK UCITS (two months) or an LTAF (six months).

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

The pre-marketing of retail funds is subject to the financial promotion regime (see **2.3.5 Rules Concerning Pre-Marketing of Alternative Funds**), which requires financial promotions to be approved by an authorised firm.

3.3.6 Rules Concerning Marketing of Retail Funds

A "retail investor" is defined as any investor that does not meet the necessary criteria in MiFID, unless it can be treated as an "elective professional client" (see **2.3.10 Investor Protection Rules**).

UCITS and NURS funds can be marketed generally to retail investors in the UK. UK UCITS and NURS funds cannot be marketed to investors living in EU countries, unless the fund is approved by the regulators in each country and complies with the terms for regulated funds in each country.

Although QISs also fall within the UK AIFMD Regime, they may only be marketed to experienced investors who meet certain qualifying conditions.

The ability for EU UCITS to passport into and out of the UK was revoked when the UK withdrew from the EU. The Temporary Marketing Permissions Regime (TMPR) was created to allow EU UCITS that were using their marketing passport in relation to the UK to continue to market to UK retail investors for a limited period.

Schemes domiciled overseas that are not in the TMPR, including those in non-EU countries, can be recognised in the UK under the process set out in Section 272 of the FSMA. This recognition route requires the FCA to undertake an in-depth assessment of the individual scheme and its country's legislative regime. The FCA must be satisfied that a scheme meets several tests in legislation and affords adequate protection to investors (including an assessment of the suitability of both the operator and depositary). This is a lengthy and time-consuming process.

On 30 September 2024, the FCA opened its new gateway for applications to be made under the Overseas Funds Regime (OFR), which operates on the principle of equivalence: if the UK government deems a jurisdiction equivalent, firms in that jurisdiction may apply to the FCA for the relevant fund to be recognised. The application is less onerous than the process under Section 272 but the FCA still requires significant information to be submitted as part of the application for recognition. EU UCITS have been recognised by the FCA as equivalent to UK UCITS, and EU UCITS operating under the TMPR are currently being invited to apply for recognition under the OFR.

3.3.7 Marketing of Retail Funds

Authorisation of a UK fund by the FCA as a UCITS or NURS entitles it to be marketed to UK retail investors.

3.3.8 Marketing Authorisation/Notification Process

Investment funds must be authorised or recognised by the FCA in order to be promoted to retail investors in the UK (see **3.3.4 Regulatory Approval Process**).

3.3.9 Post-Marketing Ongoing Requirements

Before a fund is made available to retail investors, a KID will need to be drawn up (in English) in the UK in accordance with the UK PRIIPs Regulation (see **3.1.4 Disclosure Requirements**). The UK PRIIPs Regulation requires the KID to be updated regularly, and to be updated when the review indicates that changes need to be made. Currently, however, there is an exemption for UCITS funds, which can continue to use a UCITS KIID until the end of 2026, by which time the FCA is likely to have completed a full overhaul of the KID disclosure regime.

The FCA introduced a consumer duty in 2023, designed to provide a higher level of consumer protection in retail financial markets, which includes ongoing requirements in respect of the firm-consumer relationship.

3.3.10 Investor Protection Rules

In the UK, there are both legal and regulatory requirements for retail funds to produce periodic reports every six months. Managers must prepare and publish annual and semi-annual reports, and make them available upon request and free of charge.

The FCA has the power to require a manager and/or depositary to compensate an authorised fund in the event of a finding against the manager and/or depositary. It also has the power to fine those entities and to fine or ban individuals in those companies.

In addition, authorised fund management is covered by the Financial Ombudsman Service and the Financial Services Compensation Scheme, which each deal with investor complaints and can require managers to compensate investors in certain circumstances.

3.3.11 Approach of the Regulator

See **2.3.11 Approach of the Regulator**.

3.4 Operational Requirements

The FCA Handbook sets out stringent requirements as to the operation of authorised retail funds, including that a depositary must be appointed. The fund must also establish and apply remuneration practices and policies, and publish its remuneration policy.

There are also restrictions on authorised retail funds in relation to borrowing and the types of investments such funds can make. NURS have greater flexibility, with differing borrowing and investment restrictions, and are popular for real estate investment through the PAIF structure.

3.5 Fund Finance

UCITS funds are subject to prescriptive rules on borrowings, as prescribed under the UCITS Directive.

A UCITS is permitted to borrow money for use by the fund, provided it will be repaid out of the scheme property and does not conflict with any restrictions on borrowing that may have been included in the fund's Instrument of Incorporation. This borrowing is permitted on a purely temporary and infrequent basis, and must not exceed 10% of the total value of the fund's assets on any day. Prior consent for any borrowing must be obtained from the depositary, or for periods of borrowing that may exceed three months.

The same 10% borrowing limit applies for NURS, but there is no restriction on the length of time for which a NURS may borrow. QISs have the ability to borrow up to 100% of the fund's NAV. Where derivatives are used, a QIS must ensure that its total exposure to derivatives does not exceed its NAV.

3.6 Tax Regime

General

See **2.6 Tax Regime** (General).

OEICs (Other than PAIFs) and AUTs

Tax position of the fund

OEICs and AUTs are subject to UK corporation tax, but are exempt from tax on chargeable gains from the disposal of assets (provided that the gains do not represent profit on trading transactions). Furthermore, if these funds satisfy the "genuine diversity of ownership" condition (GDO), then certain capital profits from investment transactions should be treated as exempt capital gains. For the GDO to be met, the fund must be sufficiently widely marketed. An LTAF can also be treated as meeting the GDO if at least 70% of its shares or units are held by certain institutional investors (or by the manager of the fund in its capacity as manager). Failure to meet the GDO has wider consequences for QISs and LTAFs, such that, broadly, they are taxed under normal corporation tax rules rather than the (more generous) ones that typically apply to authorised funds.

OEICs and AUTs can also potentially benefit from the general exemption from corporation tax on dividends.

OEICs and AUTs must allocate for distribution as dividends or interest the total amount available for income allocation. An OEIC or AUT can only show an amount as available for distribution as interest if it meets the qualifying investments test (such funds are often called "bond funds"). Broadly, it meets this test if the market value of investments that produce interest (or a return similar to interest) exceeds 60% of the market value of the fund's total investments. If this test is met, the distribution is generally allowable as a deductible expense for the fund for corporation tax purposes.

The net effect of the tax deduction is that bond funds should typically have little to no tax leakage at the level of the OEIC/AUT. If the qualifying investments test is not met, then all of the income available for distribution must be classed as dividends (and there would be no corresponding deduction for such payments by the fund to the extent interest is included in such distribution). Whether or not any corporation tax will be payable for a fund that does not meet the definition of a bond fund therefore depends on the level of interest income and deductible management expenses. Any corporation tax paid by an OEIC or AUT is not creditable for investors.

No withholding tax should apply to distributions paid to investors by OEICs or AUTs.

Because their income profits are taxable at the basic rate of income tax, OEICs and AUTs are "subject to tax" for double tax treaty purposes. As such, they can benefit from the UK's extensive network of double tax treaties, which can help reduce withholding taxes in other jurisdictions and assist in claiming credit for foreign taxes incurred on foreign sources of income.

It is possible for OEICs and AUTs to elect to be treated as "tax elected funds", which would modify the tax treatment relating to OEICs and AUTs from that discussed above. However, in practice, the uptake of this regime has been low, so it is not discussed further here. The regime is most appropriate for funds with a mix of debt and equity investments that do not qualify for bond fund treatment.

Tax position of the investor

UK tax resident individuals will be taxed on dividend distributions in the same way as for dividends they receive from normal companies. Therefore, UK tax resident individuals will be subject to income tax, at rates of up to 39.35%.

However, for UK corporation taxpayers, the normal dividend distribution rules do not apply (ie, that dividends received from a UK corporate are usually tax exempt in the hands of a UK corporate taxpayer). Instead, special anti-avoidance rules need to be considered (called the corporate streaming rules), which are designed to prevent corporate investors using OEIC or AUT structures to convert interest-type income into exempt dividend income. The rules are complicated, but in general terms dividend distributions are streamed into franked and unfranked parts following a formula set out in the legislation. In effect, the aim is to tax corporate investors as if they had invested in the underlying assets of the OEIC or AUT directly.

Interest distributions are, broadly, treated as interest receipts, so UK resident individuals will be subject to income tax (at rates of up to 45%).

Corporation taxpayers are required to treat their units in bond funds as creditor loan relationships for the purposes of the corporation tax rules relating to corporate debt.

PAIFs

Tax position of the fund

As mentioned above, OEICs that invest in real estate can be structured as PAIFs (provided the necessary conditions are met). PAIFs are subject to a significantly modified version of the OEIC tax regime described above. An important extra benefit of the PAIF status is that, broadly, a PAIF (unlike a normal OEIC) is exempt from corporation tax on the net income of its property investment business.

Special streaming rules apply to PAIFs. Broadly, the total amount available for income allocation by a PAIF must be split into three pools comprising property income distributions, interest distributions and dividend distributions. Interest distributions should be deductible expenses for the PAIF when calculating the net income of the non-tax-exempt part of its business.

Payments of property income distributions are subject to withholding tax (currently at 20%), unless an exemption applies (for example, if the PAIF has a reasonable belief that the person beneficially entitled to the payment is a UK tax resident company). Depending on its particular circumstances, a non-UK resident investor may be able to reclaim under a double tax treaty all or part of any tax withheld from property income distributions paid to it. No withholding tax should apply to payments of interest or dividend distributions.

Tax position of the investor

In relation to PAIFs, broadly, for recipients, property income distributions are taxed as profits of a UK property business, so UK resident individuals are subject to income tax on them (at rates of up to 45%), and credit should be given for tax withheld on payment of the PID. Corporation taxpayers will treat them as taxable income.

Interest distributions are, broadly, treated as interest receipts, so UK resident individuals will be subject to income tax (at rates of up to 45%), and corporation taxpayers will treat them as taxable income under the loan relationship rules.

Dividend distributions are taxed as dividends on shares in the normal way. Therefore, UK tax resident individuals will be subject to income tax, at rates of up to 39.35%, and corporation taxpayers can potentially benefit from the general UK company exemption from tax on dividends.

ACSs

Tax position of the fund

ACSs can take the form of either co-ownership schemes (CoACSs) or limited partnerships. However, the tax discussion in this chapter is confined to CoACSs, which is the more common ACS structure.

A CoACS is not subject to tax in the UK as it is not a body corporate and has no legal personality. Distributions to investors from CoACSs should generally not be subject to withholding tax (although withholding may be required if a CoACS has UK property income and non-UK resident investors).

Tax position of the investor

From the perspective of a UK investor, CoACSs are transparent with respect to income from a tax perspective but are treated as opaque with respect to the taxation of capital gains.

For the purposes of tax on income, investors in a CoACS are therefore treated as if they directly received the income arising from its assets. Accordingly, the tax treatment of an investor in relation to such income will depend on the investor's own tax position.

For capital gains purposes, an investor's interest in the underlying assets of the CoACS is disregarded and instead its holding of units in the scheme is treated as an asset. This simplifies the computation of the participant's chargeable gains or losses as they are regarded as having a single asset rather than many separate assets, and they can only incur a chargeable gain or loss on a disposal of their interest in the fund. The rules for computing chargeable gains and losses generally operate in the normal way, as they would for shares and securities.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Following the end of the Brexit transition period, the UK government placed considerable emphasis on the potential opportunities to create what it hoped would be a more competitive financial services sector post-Brexit, while preserving high regulatory standards tailored to the UK's needs. There have been substantive developments in this area since 2022.

Qualifying Asset Holding Company

In April 2022, the UK introduced a competitive new tax regime for qualifying asset holding companies (the QAHC Regime). The QAHC Regime is an elective tax-privileged regime available to certain UK resident asset holding companies that are owned by funds or institutional investment structures in order to hold investment assets. The main focus of the regime is on alternative fund structures, which are typically closed-ended, non-retail funds that hold assets across a range of private market investment strategies – chiefly credit, private equity and real estate investments.

The QAHC Regime is designed to improve the competitiveness of the UK as a location for asset holding companies (as compared, in particular, to Ireland or Luxembourg) by better enabling the tax-efficient flow of income and gains from the underlying investments back through the fund structure to investors so that, for UK tax purposes, investors are broadly taxed as if they had directly invested in the underlying assets, with the QAHC paying tax on only a small transfer-priced margin to reflect the activities that it performs. For non-UK fund structures, a UK QAHC has the advantage that substance (which is becoming increasingly important) can more easily be achieved where the investment management team is in the UK.

In broad terms, among other conditions, in order to qualify as a QAHC a company needs to be at least 70% owned by:

- qualifying investment funds – ie, funds that:
  (a) are widely held;
  (b) are closely held but held by certain categories of institutional investors (such as most pension funds); or
  (c) meet a diversity of ownership condition; or
- certain institutional investors directly.

There is also a requirement that the QAHC does not carry out trading activities.

Reserved Investor Fund

On 6 March 2024, the UK government published its response to its consultation on a new type of unauthorised contractual scheme fund structure, referred to as a reserved investor fund (contractual scheme) (RIF), which ended on 9 June 2023. The RIF is designed to complement and enhance the UK's existing funds regime by meeting industry demand for a UK-based unauthorised contractual scheme with lower costs and more flexibility than the existing authorised contractual scheme. The RIF will be open to professional and institutional investors, and it is expected to be particularly attractive for investment in commercial real estate. The RIF is expected to be legislated for in the Finance (No 2) Bill 2024, with detailed tax rules to follow in secondary legislation.

Financial Services and Markets Act 2023

On 29 June 2023, the Financial Services and Markets Act 2023 (FSMA 2023) was enacted. Among other things, the FSMA 2023 is intended to implement the findings of HM Treasury's Future Regulatory Framework (FRF) Review. Launched in light of Brexit, the FRF Review was described by UK Finance as "a once in a generation assessment of the legislative framework in which the financial services regulators operate". The changes implemented by the FSMA 2023 will involve the revocation of the huge body of

EU law that the UK essentially inherited when it left the EU, to be replaced by domestic rules. The provisions will come into force over several years on dates appointed by HM Treasury in statutory instruments.

Other Reforms

In July 2022, HM Treasury published the outcome of the UK Secondary Capital Raising Review, which followed on from the 2021 Lord Hill review recommendations and subsequent call for evidence, and looked at ways in which to improve the secondary fundraising process for UK listed companies so that it is cheaper, quicker and more efficient. Following this, the FCA's new listing rules came into effect on 29 July 2024.

In December 2022, the UK Chancellor of the Exchequer announced a series of wide-ranging reforms to the financial services sector in the UK, to take effect over the next few years (referred to as the Edinburgh Reforms), which include the legislation and regulation relevant to alternative funds, retail funds and their managers. Overall, progress has been slow but key measures announced include the repeal of the UK PRIIPs Regime, with the new legislation in force from November 2024.

Finally, on 26 October 2023, certain proposed amendments to the LP Act 1907 were published, by way of the Economic Crime and Corporate Transparency Act 2023 (ECCTA 2023). ECCTA 2023 implements a number of changes to the legislation on limited partnerships and creates new offences and penalties, including criminal sanctions, against the partners of limited partnerships in certain circumstances. Timing for implementation is still unclear but the key changes will include:

- requiring more information about the partners to be filed, including on individual limited partners (although it will not all be publicly available), and controls on who can file the information by requiring certain filings to be made by an authorised corporate service provider (which is subject to anti-money laundering regulations);
- requiring limited partnerships, both new and existing, to have a firmer connection to the part of the UK in which they are registered (by having to maintain their registered office there, as distinct from their principal place of business);
- requiring all UK limited partnerships (not just Scottish limited partnerships) to file confirmation statements confirming that the information held about them on the register is correct; and
- enabling the deregistration of a limited partnership in certain circumstances.

USA

Canada
United States of America
Washington DC
Mexico

Law and Practice

Contributed by:
Bill Sturman, Matthew Holt, Steven Starr and Cliff Cone
Clifford Chance

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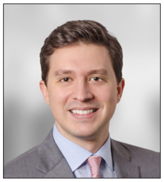
Clifford Chance is one of the world's largest law firms, with significant depth and range of resources across five continents. The global funds and investment management group – one of only four practices ranked Band 1 by Chambers Global – is comprised of more than 250 lawyers across the Americas, Europe, Asia Pacific and the Middle East. The firm advises clients throughout the full fund life cycle, from fund structuring through marketing and ongoing operational, regulatory and tax issues, to end-of-life issues such as GP-led restructurings and stapled secondaries. The highly experienced fund finance team has advised on the full spectrum of financing transactions for leading international sponsors and their lenders. The team's expertise covers the full range of fund financing products, including NAV facilities, subscription facilities, GP/manager lines, preferred equity structures, hybrid facilities and repos, as well as the wider private credit and leveraged finance products.

Authors

Bill Sturman is a partner in Clifford Chance's funds and investment management practice in New York. He advises sponsors of open- and closed-end private investment funds, including buyout, growth capital, real estate, infrastructure, secondaries, hedge, debt and hybrid funds. Bill also represents market-leading secondaries fund sponsors on the purchase and sale of fund interests. He advises clients on seeding arrangements for early generation funds and has extensive experience advising fund sponsors and investment professionals on carried interest programmes. Bill commonly represents investors on alternative investment funds and family offices in connection with the structuring and implementation of their investment strategies.



Matthew Holt is counsel in Clifford Chance's private funds practice in Washington, DC. Matthew's practice focuses on sponsor-side fund formation work across a diverse range of open- and closed-end fund products, including private funds, managed accounts, co-investment vehicles and fund-of-one vehicles in the USA, Europe and Asia. Matthew has extensive experience managing all aspects of the fund formation process, including drafting offering and governing documents, conducting investor negotiations, navigating US and global regulatory compliance and implementing tax-efficient sponsor ownership and control structures, across credit, energy, infrastructure, real estate, healthcare and consumer goods industries.

Steven Starr is counsel in Clifford Chance's global financial markets practice in New York. His practice is focused on representing borrowers and lenders in fund finance transactions, including in connection with NAV loans, subscription lines, credit facilities for '40 Act funds, multi-jurisdictional financings, and preferred equity structures. In addition to his fund finance practice, Steven has advised clients on a wide variety of financing transactions, including receivables purchase facilities, leveraged finance, operating company facilities, private credit, factoring, marketplace lending facilities, consumer and student loan financings, and margin loans.

Cliff Cone is a partner in the New York office of Clifford Chance and the co-head of the US funds and investment management practice. He focuses primarily on the investment management sector and has a broad base of expertise advising alternative investment managers, registered investment companies, BDCs, specialty finance companies and boards of directors with respect to all aspects of the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Cliff has extensive experience with the organisation and ongoing representation of US-registered open-end and closed-end investment companies, hedge funds, private equity funds, ETFs and BDCs.

Clifford Chance US LLP

Two Manhattan West
375 9th Avenue
New York
NY 10001
USA

Tel: (212) 878 8000
Fax: (212) 878 8375
Email: OnlineLegalEnquiries@CliffordChance.com
Web: www.cliffordchance.com

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Contributed by: Bill Sturman, Matthew Holt, Steven Starr and Cliff Cone, **Clifford Chance**

1. Market Overview

1.1 State of the Market

The United States continues to be a leading centre for investment funds across all strategies and asset classes. Despite a general decrease in fundraising activity since 2021, the fundraising market in the United States remains robust, and many sponsors have had success adapting to changing market dynamics. Among other adaptive strategies, the US market has seen:

- a continued trend toward consolidation of smaller asset managers with larger asset managers, which can provide a stronger brand name to accelerate fundraising efforts;
- widespread innovation in fund product design to facilitate access to retail investor capital;
- expansion of liquidity solutions for late-stage funds through a variety of GP-led secondary transactions, including continuation funds;
- a rise in market acceptance of NAV-based lending as an additional liquidity and value-creation tool during a time of decreased M&A and IPO activity;
- a shift toward strategies that have performed well and provided for regular distributions in a higher interest rate environment (eg, private credit) and away from strategies that have struggled under recent macroeconomic conditions (eg, real estate); and
- increased interest in specialised and niche strategies (eg, artificial intelligence and data-focused funds).

Looking forward, sponsors are optimistic that deal activity will continue to ramp up in the near term, suggesting a less challenging fundraising environment may lie ahead as investor capital frees up.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Limited Liability Entities

Alternative funds are typically formed as either limited partnerships or limited liability companies (LLCs) under Delaware law. Both limited partnerships and LLCs provide several advantages for alternative funds:

- they provide significantly more flexibility than other entity types (eg, corporations) to modify profit sharing (as between the fund sponsor and investors) and to customise economic and governance arrangements;
- as discussed in **2.1.3 Limited Liability**, they provide robust protection of investors' limited liability;
- they facilitate "pass-through" taxation such that the limited partnership or LLC is not subject to an entity-level tax and all items of gain and loss are passed through to the partners; and
- investors both within and outside the United States are most familiar with limited partnerships and LLCs compared to other available entity types.

The choice between a limited partnership or LLC will depend on the business objectives of the fund, tax considerations, the degree of recognition of LLCs by non-US jurisdictions, and other factors. Limited partnerships are the more common choice for alternative funds, but in some cases LLCs may provide additional flexibility in designing the fund, including the ability to institute familiar corporate governance concepts such as a board of directors.

Investor Interests

Investors in limited partnerships or LLCs generally hold limited partnership interests or LLC membership interests representing a proportionate share of the assets of the partnership or LLC. Limited partnership interests and LLC membership interests are not generally represented by shares or certificates in the same manner as interests in corporate entities.

2.1.2 Common Process for Setting Up Investment Funds

Registration/Approval Requirements

An alternative fund offered in the United States as an exempt private placement is not generally required to register or obtain approval prior to marketing to investors or accepting commitments from investors. That said, the investment adviser may separately be subject to a registration requirement with the Securities and Exchange Commission (SEC) or relevant state regulator in order to engage in an investment advisory business in the United States unless an exemption from registration is available, as discussed in **2.3.3 Local Regulatory Requirements for Non-Local Managers**.

Once the fund begins accepting investors, the fund will be required to make a public notice filing on Form D if the fund is relying on the exemption provided by Regulation D discussed in **2.2.3 Restrictions on Investors**. The Form D is due no later than 15 days after the date the first investor has made an irrevocable commitment to invest in the fund, unless the fund has opted to pre-file in advance of the closing date. The Form D requires the fund to disclose basic details regarding the offering, including the name and address of the fund and its control persons, the name and address of any placement agents retained in respect of the fund, and the aggregate dollar amount of interests sold to date. Additionally, counterpart filings may be required in states where investors are domiciled under applicable "blue sky" laws of each state.

Key Documentation

While there are no strict requirements regarding the documents required to offer an alternative fund to accredited investors in the United States, the following key documents typically govern the offering and the fund's terms.

- Private Placement Memorandum: There is no prospectus requirement with respect to private placements. However, it is common practice for alternative funds to issue a private placement memorandum or similar offering document to provide information regarding the fund sponsor, the fund's investment strategy, the relevant market, risk factors and conflicts of interest, and other important information relevant to a decision to invest. See **2.3.6 Rules Concerning Marketing of Alternative Funds** for a discussion of rules relating to the content of offering documents.
- Operating Agreement: The fund will have an operating agreement (often either a limited partnership agreement or LLC agreement) that governs ongoing terms of the fund as between the fund sponsor and the investors, including with respect to investment restrictions, economic terms, payment of expenses, investor governance rights, resolution of conflicts of interest, and periodic reporting and notice requirements.
- Subscription Agreement: In order to subscribe for an interest in the fund, investors are typically required to execute a subscription agreement (and complete a related questionnaire) confirming the amount of the investor's commitment to the fund and certain other relevant matters, including the investor's agreement to be bound by the terms of the operat-

ing agreement and the investor's qualification to invest under applicable securities laws.

- Side Letters: It is fairly common for the fund sponsor to negotiate separate side letter agreements with certain investors that modify the terms of the operating agreement as applied to the applicable investor. Side letters are used frequently to address special regulatory, policy, or tax matters applicable to specific investors, and may also cover preferential economic terms, reporting and transparency rights, and representations and warranties.

Timeline and Costs

While the process of launching an alternative fund is far more streamlined than a public offering, the fundraising process can still require significant time and costs. Various factors will impact the length and cost of the process, including the complexity of the fund's investment strategy, the size and diversity of the fund's investor base, the strength of the fund sponsor's track record and investor relationships, and general economic conditions. Although these factors vary greatly from fund to fund, it is not uncommon for the fund's operating documents to provide a fundraising period of twelve or more months for the fund sponsor to raise enough capital to reach its target size.

2.1.3 Limited Liability

Provided they do not participate in the management or control of the fund, investors in alternative funds formed as limited partnerships or LLCs do not have any personal liability to the fund, to the other partners or members of the fund, or to the fund's creditors for the debts, liabilities, or other obligations of the fund. As a result, an investor's liability is generally limited to the amount of its capital commitment to the fund, except to the extent the fund's governing documents require investors to contribute amounts in excess of their capital commitments in order to fund certain expenses, liabilities, or other obligations of the fund, subject to the limits and conditions agreed between investors and the fund sponsor.

2.1.4 Disclosure Requirements

Alternative funds are generally subject to minimal disclosure and reporting obligations relative to registered funds and public companies. As noted in **2.1.2 Common Process for Setting Up Investment Funds**, there is no prospectus requirement with respect to offerings solely to accredited investors. With the exception of the Form D filing requirement discussed in **2.1.2 Common Process for Setting Up Investment Funds**, the securities laws follow a principles-based approach with respect to regulation of what fund sponsors can and cannot say to investors in the course of a fund offering to ensure that investors receive all material information relevant to making a decision to invest and that the information disclosed is not misleading.

After the alternative fund has admitted investors, ongoing disclosure and reporting requirements are primarily dictated by the operating agreement negotiated between the fund sponsor and investors. Typically, fund terms will include a requirement for the fund sponsor to delivery quarterly reports to investors as well as annual financial statements that have been audited by a reputable audit firm. These disclosures are not provided to regulators and are not generally made publicly available.

Additionally, the investment adviser to the fund may be required to make an annual filing via Form ADV, which generally contains biographical information about the adviser's business, including high-level information on the fund and its service providers.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

The investor base for alternative funds has historically been primarily composed of large, institutional investors – eg, government and corporate pension plans, university endowments, non-profit organisations, sovereign wealth funds, insurance companies, and family offices. High net worth individuals may also invest in alternative funds provided they meet the applicable qualification standards imposed by the fund.

2.2.2 Legal Structures Used by Fund Managers

Sponsors of alternative funds typically organise a special purpose vehicle (usually a limited partnership or LLC) to serve as the general partner or managing member of an alternative fund. The general partner or managing member exercises day-to-day control of the fund and is frequently the party entitled to receive any carried interest or similar profits interest with respect to the fund.

The fund then separately engages the sponsor's investment adviser entity (which is also typically structured as a limited partnership or LLC) to serve as the investment adviser to the fund. The investment adviser, rather than the general partner or managing member of the fund, typically receives the management fee payable by the fund.

2.2.3 Restrictions on Investors

Securities Act

Under Regulation D of the Securities Act of 1933 (the "Securities Act"), interests in an alternative fund may be offered to an unlimited number of investors that qualify as "accredited investors" and up to 35 non-accredited sophisticated investors (ie, investors that have knowledge and experience in financial and business matters and are capable of evaluating the merits and risks of the prospective investment). In practice, many alternative funds choose to exclude non-accredited investors in order to avoid being subject to additional disclosure obligations that apply only to non-accredited investors. See **2.3.7 Marketing of Alternative Funds** for a discussion of additional conditions applicable to alternative funds seeking to rely on Regulation D.

Additionally, an alternative fund will be disqualified from relying on the Regulation D exemption under the "bad actor" rule if any investor that owns 20% or more of the total voting power of the fund is considered a "bad actor" as a result of being subject to a criminal conviction, regulatory or court order, or other disqualifying event covered by the rule.

Investment Company Act

Alternative funds offered through a private placement will also typically rely on one of several available exemptions from registration as an investment company under the Investment Company Act of 1940 (the "Investment Company Act") (which would subject the fund to requirements applicable to registered funds, as summarised in **3.3.9 Post-marketing Ongoing Requirements**). The two primary exemptions used by alternative funds under the Investment Company Act require the alternative fund to either:

- limit the number of investors so that the fund is not owned by more than 100 persons; or
- limit investors to only those that have sufficient investible assets to be considered "qualified purchasers".

Generally, an investor will be considered a "qualified purchaser" if it falls into one of a few enumerated categories, including if it is (i) a natural person that has at least USD5 million of investments or (ii) an entity that has at least USD25 million of investments.

Exchange Act

An alternative fund relying on Regulation D and the qualified purchaser exemption would not be subject to a cap on the number of investors under the Securities Act or the Investment Company Act. However, the Securities Exchange Act of 1934 (the "Exchange Act") separately provides that an alternative fund with 2,000 or more investors would be subject to onerous public reporting and record-keeping requirements. As a result, alternative funds will generally seek to limit the number of investors to 1,999 or less.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Alternative funds are generally subject to less regulatory scrutiny than their retail fund counterparts, and the offering of interests in alternative funds is primarily governed by three legal regimes: the Securities Act, the Exchange Act, and the Investment Company Act. Additionally, investment advisers to alternative funds are governed by the Investment Advisers Act of 1940 (the "Advisers Act").

Securities Act

Under the Securities Act, any offering of securities with a US nexus must be registered with the SEC, unless an exemption from registration is available. While public offerings in the United States must be registered under the Securities Act, private placements of securities are exempt from registration and offer funds an opportunity to avoid the costs, restrictions, and compliance burdens associated with registration. A private placement is an offer or sale of securities that is made in reliance on Section 4(a)(2) of the Securities Act or Regulation D or Regulation S thereunder.

Exchange Act

Rule 10b-5 under the Exchange Act prohibits funds from engaging in fraud, making any untrue statement of a material fact, or omitting to state a material fact necessary in order to make the statements made not misleading. A fact is material if there is a "substantial likelihood" that a reasonable investor would consider it important in its decision-making. In order to avoid potential liability under this rule, the fund and the fund sponsor should ensure that the offering documents and marketing materials are complete, accurate, and truthful. The Exchange Act also governs the activities of registered broker-dealers, who act as placement agents to funds and their investment advisers.

Investment Company Act

All entities that fall under the definition of an "investment company" that issues securities to US persons, whether publicly or privately, must either register as an investment company under the Investment Company Act or find an exemption from such registration. An issuer who falls under the definition of "investment company" and cannot rely on an available exemption would be required to register with the SEC, and, accordingly, be subject to an array of substantive requirements, including, among other things, public filings and financial reporting, limits on affiliate transactions, limits on capital structure (ie, asset coverage restrictions), and compliance and record-keeping burdens.

Alternative funds typically rely on one of the explicit exclusions from the definition of "investment company" available under Section 3(c) of the Investment Company Act. These exclusions include alternative funds that limit their investors to no more than 100 persons or that limit their investors to "qualified purchasers", as described in **2.2.3 Restrictions on Investors**.

Commodity Exchange Act

Certain alternative funds that trade swaps, commodities, futures, or derivatives and their investment advisers may be regulated by the Commodity Futures Trading Commission under the Commodity Exchange Act (CEA). In particular, certain alternative fund general partners or managing members may need to register or seek exemption from registration as a commodity pool operator and their investment advisers may need to register or seek exemption from registration as a commodity trading adviser.

2.3.2 Requirements for Non-Local Service Providers

Generally, non-local service providers are generally not subject to US registration requirements in the alternative fund context. As noted in the preceding section, placement agents are regulated under the Exchange Act and generally need to be registered with the SEC, the Financial Industry Regulatory Authority Inc. (FINRA) and the states in which they operate. Foreign placement agents may enter into chaperoning arrangements with US broker-dealers to allow them to access the US markets without being registered themselves, subject to significant restrictions.

2.3.3 Local Regulatory Requirements for Non-Local Managers

The conduct of an investment advisory business in the United States is subject to regulation under the Advisers Act. The Advisers Act defines an "investment adviser" as any person who engages in the business of providing advice to others or issuing reports or analyses regarding securities for compensation. Alternative fund managers would generally be considered investment advisers for the purposes of the Advisers Act.

Registration of Investment Advisers

Any entity meeting the definition of an investment adviser that uses US jurisdictional means in connection with an advisory business must register with the SEC as an investment adviser under the Advisers Act or find an available exemption from registration thereunder. Registration as an investment adviser imposes legal, recordkeeping, and disclosure burdens on advisers that must be considered during the registration process. For example, SEC-registered advisers must adopt written policies and procedures and codes of ethics to govern their activities, comply with detailed disclosure and advertising restrictions, develop internal controls and procedures subject to internal audit, and meet other Advisers Act requirements. Additionally, all SEC-registered advisers are subject to SEC examination, investigation, and enforcement liability.

Exemptions

A non-local manager may avoid registration if it qualifies for one of the following exemptions:

- The foreign private adviser exemption is available to an investment adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients or investors in the US; (iii) has aggregate assets under management attributable to these US clients or investors of less than USD25 million; and (iv) does not hold itself out generally to the public in the United States as an investment adviser.
- The private fund adviser exemption is available to any investment adviser whose principal

place of business is outside the United States and that solely advises one or more qualifying private funds, if the adviser's assets under management from a place of business in the United States are, in the aggregate, less than USD150 million.

Reporting Obligations of Exempt Advisers

An adviser that qualifies for and elects to rely on the private fund adviser exemption must make filings with the SEC as an exempt reporting adviser (ERA) within 60 days of first relying on such exemption. While not subject to registration or the full scope of the substantive provisions of the Advisers Act, an ERA is required to comply with several provisions of the Advisers Act, as well as certain rules and regulations thereunder.

An adviser relying on the foreign private adviser exemption is not required to make any filing with the SEC.

2.3.4 Regulatory Approval Process

Filings in the alternative funds space generally do not require regulatory approval. As noted in **2.1.4 Disclosure Requirements**, notice filings may need to be made with federal regulators after the fund has been sold in the United States and with individual states thereof.

2.3.5 Rules Concerning Pre-Marketing of Alternative Funds

The United States does not distinguish between pre-marketing and marketing in the same manner as some other jurisdictions.

2.3.6 Rules Concerning Marketing of Alternative Funds

As noted in **2.3.1 Regulatory Regime**, Rule 10b-5 under the Exchange Act prohibits funds from engaging in fraud, making any untrue statement of a material fact, or omitting to state a material fact necessary in order to make the statements made not misleading.

Additionally, an investment adviser to an alternative fund may be subject to Rule 206(4)-1 under the Advisers Act (the "Marketing Rule"). The Marketing Rule imposes a set of principles-based disclosure rules applicable to advertisements of a registered investment adviser and requires, among other things, the publication of "net" performance metrics any time gross performance is shown and limitations on the use of hypothetical and predecessor performance. When a placement agent is used, FINRA rules may also impact the way an alternative fund is marketed.

2.3.7 Marketing of Alternative Funds

Regulation D

As noted in **2.3.6 Rules Concerning Marketing of Alternative Funds**, alternative funds commonly rely on the exemption from registration provided by Regulation D of the Securities Act. Regulation D includes two main exemptions from registration for offers and sales of securities by issuers: Rule 506(b) and Rule 506(c). The key difference between these two exemptions is that Rule 506(b) prohibits the use of "general solicitation" and "general advertising" in connection with offerings, while Rule 506(c) allows the use of general solicitation and general advertising, provided that the issuer takes reasonable steps to verify that all purchasers of securities are "accredited investors".

Restriction on General Solicitation and General Advertising

In practice, many alternative funds rely on the exemption provided by Rule 506(b), and therefore are prohibited from engaging in general solicitation or general advertising while the offering of interests in the fund is ongoing. Frequently, fund sponsors will avoid general solicitation by conducting the offering of interests in the fund so that the offering reaches only those who have a pre-existing relationship with the fund sponsor. Additionally, the fund sponsor will be prohibited from engaging in any advertising activity that could have the effect of conditioning the market or soliciting investors for the offering.

Investment Company Act

As noted in **2.2.3 Restrictions on Investors**, an alternative fund may also be restricted to selling interests solely to persons who are "qualified purchasers" depending on the exemption applicable to the fund.

2.3.8 Marketing Authorisation/Notification Process

No authorisation or notification is required prior to marketing an alternative fund.

2.3.9 Post-Marketing Ongoing Requirements

If an alternative fund has filed a Form D, it will be obligated to update the filing on an annual basis for so long as the fundraising continues, and more frequent updates may be necessary depending on whether there are material changes to the information contained therein. Some states may also require updates to be made to their state-level notice filings. Depending on the type of investment, some alternative funds may be subject to additional federal filing obligations.

An investment adviser to an alternative fund that is registered with the SEC or is an ERA will be required to update its Form ADV on an annual basis (and more frequently if certain information changes). Certain registered investment advisers will also be required to file a Form PF with the SEC on a periodic basis, including information about the private funds that they advise or manage.

2.3.10 Investor Protection Rules

Generally, participation in alternative funds by US investors is restricted to investors that meet applicable sophistication requirements. These eligibility thresholds allow the alternative fund to avoid the burdensome registration requirements of the Securities Act and Investment Company Act (which provide heightened protection for retail investors). Depending on the type of investment, some alternative funds may be subject to additional federal filing obligations.

2.3.11 Approach of the Regulator

The SEC generally communicates via email or telephone with alternative fund sponsors; face-to-face meetings are uncommon. As alternative funds are not directly regulated, the most common source of interaction with the regulator comes in the form of examinations of a fund's investment adviser. Registered investment advisers are regularly examined by the SEC for compliance with federal securities laws.

2.4 Operational Requirements

Broadly, there are no regulatory restrictions on the types of investments for alternative funds. However, an investment adviser to an alternative fund will be subject to certain provisions of the Advisers Act that may have operational impacts. For example:

- An investment adviser has a fiduciary duty, comprised of a duty of loyalty and a duty of care, and must comply with this duty in its dealings with its clients (which, in the case of an advisory client that is an alternative fund, would be the fund itself rather than the investors in the fund). Careful attention must be paid to conflicts of interest, which must generally be disclosed and mitigated.

- Rule 206(4)-2 (the "Custody Rule") requires a registered investment adviser who has (or whose affiliates have) custody of client funds or securities to comply with certain safeguarding and audit requirements.
- The Advisers Act prohibits an investment adviser from buying securities from or selling securities as principal to a client account without receiving informed consent from the client for the transaction.

2.5 Fund Finance

The fund finance market in the United States offers significant borrowing access for alternative funds. Financial institutions provide various financing options, such as subscription lines and NAV-based facilities, enhancing liquidity and capital efficiency.

Any borrowing restrictions are typically contained in the operating agreement of the fund. Most operating agreements authorise subscription financing, with potential limitations on borrowing duration and amounts. NAV financing may require limited partner advisory committee approval, which most lenders recommend even though it may not be specifically required by the fund's operating agreement.

Fund finance products usually involve some form of security, such as pledges over uncalled capital commitments, portfolio assets, or holding company equity.

Common issues include the necessity for careful diligence of the collateral. For subscription lines, lenders review subscription documents to ensure proper execution and matching commitment amounts. NAV facilities require diligence of organisational documents and agreements to confirm the permissibility of equity pledges and necessary consents. Fund finance deals also focus on cash flow from capital contributions or investments, requiring documentation to ensure cash passes through lender-controlled accounts before reaching the fund.

2.6 Tax Regime

Alternative funds formed in the United States are typically established as tax-transparent vehicles. As a result, investors are generally subject to US federal income tax on their allocable share of an alternative fund's income (generally, as through the investors earned their allocable share of the fund's income directly). In the case of a US federal income tax audit of an alternative fund treated as a partnership, any tax liability generally would be assessed at the alternative fund level. However, the manager of the alternative fund would generally have the ability to make an election to "push out" tax liability resulting from an audit to the alternative fund's partners.

The maximum US federal income tax rate for individual US citizens and residents is currently 37%. The maximum US federal income tax rate for US entities that are treated as corporations for US tax purposes is 21%. An individual US citizen or resident is subject to a lower US federal income tax rate for income treated as long-term capital gain, which would generally arise from the sale of assets held for investment for a period longer than one year. In addition, an individual US citizen or resident may be subject to a 3.8% tax applicable on their net investment income. The maximum US federal income tax rate for long-term capital gains is 20%. Additional state and local taxes may apply. Individual US citizens or residents may be limited in their ability to deduct certain fund-level expenses but may, under current law, be entitled to a deduction if the alternative fund generates certain “qualified business income”.

US tax-exempt investors are generally exempt from US federal income tax except for income generated (i) from a business that is unrelated to the US tax-exempt investor’s exempt purpose or (ii) from an investment that is debt-financed (such income, UBTI).

Non-US investors treated as engaged in a US trade or business are required to file US tax returns and are subject to US federal income tax for any income that is treated as “effectively connected” with that US trade or business (such income, ECI). ECI recognised by a non-US investor, including through a tax-transparent vehicle, will be taxed on a net basis at the same rates applicable to US taxpayers and will subject a non-US investor to a US tax return filing obligation. Non-US corporate taxpayers are subject to a branch profits tax (currently at a 30% rate) on effectively connected earnings and profits, which may be lowered by an applicable double tax treaty. US source income that is not ECI (such as US source dividends or interest) is generally subject to US federal withholding tax on a gross basis at a 30% rate, which may be lowered by an applicable double tax treaty.

To mitigate the recognition of ECI to non-US investors and UBTI to US tax-exempt investors, alternative funds often “block” such income by interposing entities treated as corporations for US federal income tax purposes between an alternative fund’s ECI or UBTI-generating assets and the alternative fund’s non-US and US tax-exempt investors.

Alternative funds may also provide for parallel and feeder vehicles in order to accommodate the needs of different categories of investors and, in addition to potentially making investments through holding vehicles treated as corporations for US federal income tax purposes, may also make investments through other holding vehicles subject to special tax regimes, such as US “real estate investment trusts” for real estate funds and “regulated investment companies” for credit funds.

The disposition of interests in an alternative fund held for investment will generally result in a capital gain or loss (which will be long-term or short-term depending on the holding period of the seller).

A special withholding tax regime applies to non-US investors who dispose of partnership interests.

Special considerations apply to non-US sovereigns that invest in US alternative funds.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

There are three main types of retail funds: open-end funds, closed-end funds, and unit investment trusts (UITs).

Open-End Funds

Open-end funds consist mostly of mutual funds and exchange-traded funds (ETFs). Mutual funds pool investor money and offer daily pricing, sales and redemptions of shares to investors. All mutual funds transactions are made directly with investors or through investment professionals such as brokers (and not on a listed securities exchange). Mutual funds may not offer preferred shares but may offer different share classes with different investment minimums. Mutual funds qualify for "pass-through" tax treatment, meaning that there is no taxation of the entity itself. Each mutual fund typically has an investment adviser registered under the Advisers Act, as well as a principal underwriter that is registered under the Exchange Act and is a FINRA member.

Exchange-traded funds, in contrast to mutual funds, trade intraday on listed securities exchanges. Authorised participants are financial institutions that buy and sell an ETF's shares at net asset value (NAV) in large quantities known as creation units. Authorised participants then redeem creation units in kind for a part of the ETF portfolio. The price of ETF shares is determined by both its NAV and supply and demand.

Mutual funds and exchange-traded funds may not have more than 15% of assets invested in illiquid securities. Common legal vehicles for mutual funds and ETFs are limited liability companies, limited partnerships, business or statutory trusts, and corporations.

A main advantage of open-end funds is that they often have smaller minimum investments and are generally liquid. However, as a result of allowing investors to redeem their shares at will (hence the high liquidity), a downturn in the market may cause the fund to sell at lower prices to cover the redemptions.

Closed-End Funds

Closed-end funds do not issue redeemable securities. The traditional closed-end fund typically offers a fixed number of shares in an initial public offering whose price is determined by supply and demand. In addition to the traditional model for closed-end funds, other types of closed-end funds include interval funds, tender offer funds, and business development companies (BDCs).

Interval funds and tender offer funds are not generally traded on a listed exchange. Interval funds offer shares continuously at NAV and repurchase their own shares periodically. Tender offer funds also offer their shares continuously at NAV but are not mandated to repurchase shares and only do so when authorised by the fund's board of directors. BDCs, while not registered under the Investment Company Act, generally elect to be regulated pursuant to certain provisions thereunder. BDCs are designed to provide capital to middle-market companies in the United States and their shares may be traded on- or off-exchange. BDCs generally offer profit-sharing compensation to management and may use more leverage than other funds registered under the Investment Company Act.

Unlike open-end funds, closed-end funds are not subject to the 15% limit on investing in illiquid securities. Closed-end funds are also permitted to issue preferred shares and are more likely to utilise leverage compared to open-end funds. A disadvantage of closed-end funds is that their share prices are subject to fluctuations in the market and, due to their increased use of leverage, may be susceptible to greater losses in the event of a market downturn.

Unit Investment Trusts

UITs are passive vehicles without a board of directors which have a predetermined maturity. When a UIT reaches the end of its term, the fund is terminated, and its assets are sold off. Some ETFs, such as the first ETF established in 1993, qualify as UITs. UITs are advantageous for raising capital efficiently for a specific purpose. A potential disadvantage is that should the trust terminate before the maturity of its stock, investors will lose projected gains.

3.1.2 Common Process for Setting Up Investment Funds

To register with the SEC, open-end funds and ETFs use Form N-1A, while closed-end funds and BDCs register using Form N-2 when registering their shares under the Securities Act. Both forms require the submission of a prospectus, a statement of additional information (SAI) and a section for other information such as corporate organisational documents, compliance policies, and certain material contracts. The prospectus summarises the fund's investment objectives and strategies and describes its fees and costs. The SAI provides an in-depth description of the fund's management and compensation structure.

UITs register using Form S-6 and Form N-8B-2. These forms include a prospectus and exhibits similar to the N-1A and N-2, but do not require an SAI. Privately owned BDCs register under the Exchange Act using Form 10, which calls for a description of the company's business, a list of officers and directors, and other financial information pursuant to Regulation S-K under the Exchange Act.

Once the registration statements have been filed, the SEC reviews and provides comments to which the retail fund must respond. Once the SEC decides it has gathered enough information, it will declare the registration of the fund to be effective. Open-end funds must update their registration statements each year in the form of a post-effective amendment to the Form N-1A, while closed-end funds are exempt from this requirement if they provide informative shareholder reports yearly. Setting up a retail fund is generally an expensive and time-consuming process, which can be further exacerbated based on the extent of comments from the SEC.

3.1.3 Limited Liability

All retail funds offer limited liability to their investors, as investors will not be subject to losses greater than the amount they have invested.

3.1.4 Disclosure Requirements

Under the Investment Company Act, open-end funds must provide annual and semi-annual reports to shareholders that are "visually engaging" and provide information that investors would want to know when monitoring their portfolios. ETFs are also required to provide a daily disclosure of their portfolios' holdings.

Closed-end funds must also provide annual and semi-annual reports to shareholders. BDCs report like normal reporting companies under the Exchange Act (ie, quarterly financial results on Form 10-Q, annual financial results on Form 10-K and periodic material updates on Form 8-K).

As of 2020, closed-end funds must also provide an annual management discussion of the fund's performance to the SEC under the Small Business Credit Availability Act and the Economic Growth, Regulatory Relief, and Consumer Protection Act.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

There are multiple types of investors in retail funds, including the general public investing through online brokerage platforms, as well as institutional investors, such as banks, insurance companies, pension plans, and other private or public funds.

3.2.2 Legal Structures Used by Fund Managers

Retail funds are most often structured as limited partnerships, LLCs, or statutory trusts.

3.2.3 Restrictions on Investors

Although retail funds with a public offering are allowed to sell to any investor, these funds may restrict their offerings to certain investors, such as those that meet eligibility thresholds based on net worth or income. Closed-end funds may only charge a performance-based fee on a fund's capital gains if each of the fund's US investors meets the definition of a "qualified client" under the Advisers Act.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

There are four main legal regimes that concern retail funds: the Securities Act, the Exchange Act, the Investment Company Act, and the Advisers Act. The Securities Act governs whether an issuer can offer or sell securities in the United States and broadly prohibits the use of deception, manipulation, or fraud in securities transactions. The Exchange Act established the SEC and granted it the power to regulate and discipline brokerage firms and securities exchanges. The Investment Company Act regulates both open-end and closed-end funds and ensures that investors have sufficient information to make an informed investment decision while aiming to prevent or mitigate conflicts of interest and self-dealing by the fund and/or its affiliates. The Advisers Act governs the conduct of managers providing investment advice to US clients and has plenary anti-fraud provisions that apply to investment advisers regardless of whether or not they are registered with the SEC.

Under Section 12(d) of the Investment Company Act, open- and closed-end funds cannot generally: (i) own more than 3% of the voting stock of another registered investment company (RIC); (ii) have more than 5% of their total assets in a single RIC's securities; or (iii) have more than 10% of their total assets in any number of RIC securities.

3.3.2 Requirements for Non-Local Service Providers

The Investment Company Act sets forth various requirements on specific service providers for retail funds, certain of which are specifically formulated with respect to operational differences between US and non-US providers.

3.3.3 Local Regulatory Requirements for Non-Local Managers

Non-local managers (including sub-advisers) to retail funds are required to be registered as investment advisers under the Advisers Act and are subject to the full suite of Advisers Act regulation.

3.3.4 Regulatory Approval Process

Obtaining regulatory approval from the SEC with respect to the formation of retail fund typically takes several months. The process may be longer or shorter depending on the intricacy of the fund structure and strategy and the extent of any SEC comments.

3.3.5 Rules Concerning Pre-Marketing of Retail Funds

Fund sponsors must adhere to specific rules and regulations when pre-marketing retail funds and are subject to SEC and FINRA oversight. Prior to marketing, retail funds must generally be registered with the SEC under the Securities Act. However, there may be available exemptions permitting retail funds to engage in communication with the public prior to being registered, depending on (i) the type of securities being offered; (ii) the type of communication; (iii) the intended audience; and (iv) the timing of the communication in relation to the offering.

3.3.6 Rules Concerning Marketing of Retail Funds

Fund sponsors must ensure that all marketing materials are fair, balanced, and not misleading. These materials must be filed with FINRA within ten business days of first use and must include specific disclosures, such as the fund's total annual operating expense ratio. Furthermore, depending on where and how the fund is marketed, state-specific securities laws may require additional filings or notices. Fund sponsors must also adhere to the anti-fraud provisions of the Securities Act.

3.3.7 Marketing of Retail Funds

So long as a retail fund is properly registered under the Securities Act, there are no limits on the types of investors the fund may market to, subject to any investor-eligibility requirements that may be imposed by the fund.

3.3.8 Marketing Authorisation/Notification Process

Retail funds are generally registered under both the Securities Act and the Investment Company Act but may choose to register only under the Investment Company Act. Registration under the Securities Act requires approval from the SEC before a fund can be declared effective, which can be a cumbersome and time-consuming process that involves the regulator reviewing the fund's registration statement before providing any comments to be implemented. Once the SEC declares the registration statement effective, the fund can be marketed broadly to US investors. Registering under the Investment Company Act allows a fund to go effective immediately and only requires notification to the SEC, though the fund cannot be offered publicly. Additionally, funds may need to register with or otherwise notify state securities regulators depending on the states in which they plan to market.

3.3.9 Post-Marketing Ongoing Requirements

Fund sponsors that have marketed a retail fund must adhere to several ongoing requirements to ensure transparency and regulatory compliance. On the federal level, these include filing annual and semi-annual reports with the SEC, Form N-PORT (monthly portfolio holdings filed quarterly), and Form N-CEN (annual census-type information). These filings, in addition to continuous anti-money laundering and "know your customer" obligations imposed by various federal regulations and any applicable state-specific reporting requirements, create a robust regulatory regime with which a fund must comply during the post-marketing stages of the fund's life cycle.

Further, open-end funds must calculate their NAV daily, while closed-end funds may make these calculations daily or periodically.

3.3.10 Investor Protection Rules

Regulation Best Interest ("Reg BI") broadly requires broker-dealers to act in the best interest of retail investors when recommending securities transactions. Reg BI enhances the standard of conduct beyond existing suitability obligations. With respect to regulatory reporting, retail funds must comply with the Investment Company Act, which mandates detailed disclosure and reporting requirements as described in **3.3.9 Post-Marketing Ongoing Requirements**. Retail funds must also make regular filings with the SEC, which provide transparency regarding the fund's holdings, financial condition, and performance and ensure ongoing investor protection.

3.3.11 Approach of the Regulator

The SEC engages with registrants during the filing process, generally via telephone or email. Face-to-face meetings with SEC officials also occasionally occur, particularly for complex issues, with the SEC's regional offices facilitating such interactions. Additionally, the SEC provides various channels for inquiries and feedback, including hotlines, email, and public forums.

3.4 Operational Requirements

All funds registered under the Investment Company Act, including BDCs and both open- and closed-end funds, must elect to be either diversified or non-diversified, must disclose their policy with respect to concentrating investments in an industry or a group of industries, and must appoint an authorised custodian (typically a bank) to safeguard their securities and cash and must also implement liquidity risk management programmes. Registered funds must also be advised by SEC-registered investment advisers, must have a board of directors, and, in order for the funds to avail themselves of certain rules under the Investment Company Act, a majority of these directors must be independent. The Investment Company Act also generally prohibits registered funds from engaging in transactions with their affiliates, including joint transactions, unless in compliance with certain exemptions, rules, or exemptive relief granted by the SEC.

Open-end funds generally cannot engage in short selling due to daily liquidity requirements, whereas closed-end funds may engage in short selling under certain conditions. Shares of closed-end funds trade at market prices, generally at a discount to a fund's NAV.

UITs have a fixed portfolio of securities and do not actively manage their investments. They are designed to be passively managed with a predetermined termination date. UITs must appoint an authorised trustee, typically a bank, to safeguard their assets. Due to their fixed portfolios, UITs have limited risk management requirements, generally do not engage in borrowing, and calculate their NAV only periodically. UITs cannot engage in short selling due to the fixed nature of their portfolios.

3.5 Fund Finance

Most retail funds are registered with the SEC under the Investment Company Act, which imposes limits on the amount that these funds can borrow in order to ensure fund stability and protect shareholders.

Open-end funds, such as mutual funds and ETFs, have limited borrowing capabilities. They cannot use greater than 33.3% leverage (one dollar of debt for every two dollars of equity assets, or 300% asset coverage, where asset coverage is measured as total assets, including the leverage incurred, over debt). Borrowing is typically used for short-term liquidity needs.

Closed-end funds have more flexibility in borrowing and often use leverage to enhance returns, though this may also increase a fund's volatility. These funds can issue debt and preferred shares but cannot use greater than 33.3% leverage (one dollar of debt for every two dollars of equity assets, or 300% asset coverage) or 50% (in the event leverage is obtained solely through preferred stock – one dollar of debt for every dollar of equity, or 200% asset coverage) of their total assets.

As of 2018, with board approval, BDCs are now allowed to use 100% leverage (two dollars of debt for every one dollar of equity assets, or

150% asset coverage), versus the 50% historical leverage limit.

UITs generally do not engage in borrowing. They are designed to be passively managed and have a fixed portfolio, which limits their need for leverage. The structure of UITs makes borrowing impractical and uncommon.

Lenders to registered funds often require security, usually in the form of the fund's portfolio assets. Key considerations for registered funds when utilising fund financing are compliance with regulatory borrowing limits and managing liquidity risk in connection with redemption requests from investors.

3.6 Tax Regime

Retail funds formed in the United States are typically established as "regulated investment companies" (RICs). RICs are subject to a preferential tax regime. Provided that a RIC meets certain distribution, income, and asset requirements, it will generally not be subject to US federal income tax on the income that it distributes to its shareholders. The maximum US federal income tax rate for individual US citizens and residents is currently 37%. The maximum US federal income tax rate for US entities that are treated as corporations for US tax purposes is 21%. An individual US citizen or resident is subject to a lower US federal income tax rate for income treated as long-term capital gain, which would generally arise from the sale of assets held for investment for a period longer than one year. The maximum US federal income tax rate for long-term capital gains is 20%. In addition, an individual US citizen or resident may be subject to a 3.8% tax applicable on their net investment income. Additional state and local taxes may apply.

Assuming certain requirements are met, a RIC may elect to make distributions that retain the character of income earned by the RIC. A RIC electing this treatment may, for example, distribute a "capital gain dividend" to its shareholders with respect to capital gain earned by the RIC, which would be taxable to a US individual or resident investor at lower long-term capital gains rates. Certain distributions by a RIC of ordinary income received by a US entity treated as a corporation for US federal income tax purposes may qualify for a "dividends received deduction" of 50% (or greater if the US entity treated as a corporation owns 20% or more of the RIC's shares).

US tax-exempt investors are generally exempt from US tax except for income generated (i) from a business that is unrelated to the US tax-exempt investor's exempt purpose or (ii) from an investment that is debt-financed (such income, UBTI). Subject to certain exceptions, an investment in a RIC should not cause a US tax-exempt investor to recognise UBTI.

Non-US investors are subject to US federal income tax for any income that is treated as "effectively connected" with that US trade or business (such income, ECI). Generally, an investment in a RIC is not expected to cause a non-US investor to recognise ECI or be treated as engaged in a US trade or business. With regard to US source interest, a RIC may designate an "interest-related dividend" to its shareholders with respect to certain interest earned by the RIC. If certain requirements are met, interest-related dividends distributed by a RIC to a non-US holder will not be subject to US federal withholding. US source income that is not ECI and does not qualify for an exemption (such as RIC distributions that are treated as US source dividends) is generally subject to US federal withholding tax on a gross basis at a 30% rate, which may be lowered by an applicable double tax treaty.

The sale or exchange of shares of a RIC held for investment will generally result in a capital gain or loss (which will be long-term or short-term depending on the holding period of the seller).

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

Private Fund Adviser Rules

In August 2023, the SEC adopted new rules and amendments that would have imposed sweeping reforms with respect to the regulation of investment advisers to alternative funds (the "PFA Rules"). The PFA Rules reflected the SEC's increasing scrutiny of private fund advisers and the SEC's desire to enhance protection of investors by increasing transparency, competition, and efficiency in the alternative funds market. In June 2024, a decision from the US Court of Appeals for the Fifth Circuit struck down the PFA Rules in their entirety on the basis that the SEC lacked authority to adopt the rules. To date, there has been no indication from the SEC that it intends to revisit elements of the PFA Rules in rulemakings in the near future.

AML Reporting

FINCEN has issued final rules requiring SEC-registered advisers to establish a written anti-money laundering (AML) programme with compliance dates in 2026. Under the rule, advisers are required to, among other things, establish and implement policies, procedures, and internal controls reasonably designed to prevent the adviser from being used for money laundering or the financing of terrorist activities and designate a compliance person with responsibility for implementing and monitoring the operations and internal controls of the programme.

Cybersecurity

In March 2024, the SEC adopted amendments to Regulation S-P to enhance protection of non-public personal information collected by financial institutions. Specifically, the amendments require SEC-registered advisers to have procedures to assess the nature and scope of incidents involving unauthorised access or use of customer information, identify customer information systems and types of customer information accessed or used, take appropriate steps to contain and control an incident, notify each affected individual whose "sensitive customer information" was or is reasonably likely to have been accessed or used, and to oversee, monitor, and perform due diligence over vendors.

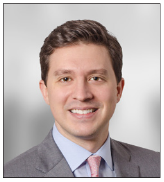
Trends and Developments

Contributed by:
Bill Sturman, Matthew Holt, Steven Starr and Cliff Cone
Clifford Chance

Clifford Chance is one of the world's largest law firms, with significant depth and range of resources across five continents. The global funds and investment management group – one of only four practices ranked Band 1 by Chambers Global – is comprised of more than 250 lawyers across the Americas, Europe, Asia Pacific and the Middle East. The firm advises clients throughout the full fund life cycle, from fund structuring through marketing and ongoing operational, regulatory and tax issues, to end-of-life issues such as GP-led restructurings and stapled secondaries. The highly experienced fund finance team has advised on the full spectrum of financing transactions for leading international sponsors and their lenders. The team's expertise covers the full range of fund financing products, including NAV facilities, subscription facilities, GP/manager lines, preferred equity structures, hybrid facilities and repos, as well as the wider private credit and leveraged finance products.

Authors

Bill Sturman is a partner in Clifford Chance's funds and investment management practice in New York. He advises sponsors of open- and closed-end private investment funds, including buyout, growth capital, real estate, infrastructure, secondaries, hedge, debt and hybrid funds. Bill also represents market-leading secondaries fund sponsors on the purchase and sale of fund interests. He advises clients on seeding arrangements for early generation funds and has extensive experience advising fund sponsors and investment professionals on carried interest programmes. Bill commonly represents investors on alternative investment funds and family offices in connection with the structuring and implementation of their investment strategies.



Matthew Holt is counsel in Clifford Chance's private funds practice in Washington, DC. Matthew's practice focuses on sponsor-side fund formation work across a diverse range of open- and closed-end fund products, including private funds, managed accounts, co-investment vehicles and fund-of-one vehicles in the USA, Europe and Asia. Matthew has extensive experience managing all aspects of the fund formation process, including drafting offering and governing documents, conducting investor negotiations, navigating US and global regulatory compliance and implementing tax-efficient sponsor ownership and control structures, across credit, energy, infrastructure, real estate, healthcare and consumer goods industries.

Contributed by: Bill Sturman, Matthew Holt, Steven Starr and Cliff Cone, **Clifford Chance**

Steven Starr is counsel in Clifford Chance's global financial markets practice in New York. His practice is focused on representing borrowers and lenders in fund finance transactions, including in connection with NAV loans, subscription lines, credit facilities for '40 Act funds, multi-jurisdictional financings, and preferred equity structures. In addition to his fund finance practice, Steven has advised clients on a wide variety of financing transactions, including receivables purchase facilities, leveraged finance, operating company facilities, private credit, factoring, marketplace lending facilities, consumer and student loan financings, and margin loans.

Cliff Cone is a partner in the New York office of Clifford Chance and the co-head of the US funds and investment management practice. He focuses primarily on the investment management sector and has a broad base of expertise advising alternative investment managers, registered investment companies, BDCs, specialty finance companies and boards of directors with respect to all aspects of the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Cliff has extensive experience with the organisation and ongoing representation of US-registered open-end and closed-end investment companies, hedge funds, private equity funds, ETFs and BDCs.

Clifford Chance US LLP

Two Manhattan West
375 9th Avenue
New York
NY 10001
USA

Tel: (212) 878 8000
Fax: (212) 878 8375
Email: OnlineLegalEnquiries@CliffordChance.com
Web: www.cliffordchance.com

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Introduction

Net Asset Value (NAV) financing has emerged as a pivotal tool for private investment funds, offering a flexible and efficient means of accessing liquidity. This financing method, which allows funds to borrow against the value of their assets, has gained significant traction in recent years. This article explores the recent trends in NAV financing, some recent commentary on NAV financings, and the implications of these developments for the documentation of NAV credit facilities.

Growth of NAV Financing

The market for NAV facilities has surged in recent years, driven by various factors. In particular:

- Challenging Environment for Exiting Investments: The primary means by which private equity funds exit their investments are either IPOs or M&A activity. Both of these exit options have experienced depressed levels of activity over the past few years. For example, in 2024 the United States saw a significant decline in IPO activity, with the number of IPOs dropping by over 50% compared to 2023. This difficult exit environment has resulted in funds holding onto their assets for longer periods of time than they normally would. As a result, funds have found themselves asset-rich and cash-poor and looking for potential sources of liquidity.
- Increasing Familiarity With the Product: Over the past several years, extensive industry discussions (including within trade groups like the Fund Finance Association) about NAV financing have increased familiarity with this offering. Law firms, fund bankers, and credit risk officers learned about this product and became increasingly comfortable with its mechanics and credit risk profile. In addition, other industry players have observed the success of (and generous returns achieved by) the initial NAV lenders in the market. All of these factors have made industry players much more comfortable with NAV financing.
- Depressed Demand for Subscription Lines: In addition, demand for subscription lines (which are credit facilities secured by the uncalled capital commitments of fund's investors) has been low for the past few years. The primary factor driving this trend has been the challenging environment for raising new investment funds. According to McKinsey's Global Private Markets Review, in 2024 fundraising fell by 22% across private market asset classes globally, reaching just over USD1 trillion – the lowest total since 2017. New fundraising is the fuel that powers the market for subscription lines, so as fundraising has dried up, so has demand for subscription facilities. This vacuum left many fund bankers looking for other options to use their balance sheet and service their fund clients, and so many turned to NAV financing.
- More Market Participants: New lenders, including banks, insurance companies, and specialty private lenders, attracted by the high spreads associated with this product, have expanded what was once a niche market into a much larger and more competitive space.
- Flexibility of the Product: The growth in NAV financing can also be attributed to the flexibility and bespoke structuring it offers. Unlike traditional financing options, NAV facilities can be tailored to suit the specific needs of a fund, taking into account its structure, investment strategy, and regulatory considerations. This has made NAV financing an attractive option for a wide range of funds, including private equity, infrastructure, and secondary funds.

Impact of Growth of NAV Financing Market on Facility Terms

As new lenders have piled into the NAV market and existing lenders have expanded their NAV loan books, market pressure has led to a loosening of some of the core terms applicable to these facilities. In particular, more established NAV lenders have observed that the entrance of newer players into the market and their willingness to accept looser terms in order to gain market share has led to a general softening of the terms for these facilities.

Loan-to-value ratio

Nearly every NAV facility will have a covenant based on the fund's loan-to-value (LTV) ratio, which limits the amount of borrowing by the fund to a percentage of the NAV. This ratio helps manage the lender's risk by capping the borrowed amount at a certain proportion of the fund's asset value, ensuring that there is sufficient value in the fund assets for the lender to be fully repaid should the facility go into default. The maximum LTV ratio in a NAV facility varies depending on the quality and liquidity of the underlying assets. In addition, the calculation of the "value" component of the LTV ratio typically incorporates eligibility criteria; only those assets that satisfy the eligibility criteria will be counted towards the calculation of the LTV ratio.

In general, LTV ratios for NAV facilities range from 5-20% for concentrated or illiquid portfolios to over 50% for very liquid and diverse portfolios. These percentages have crept up over the past year due to the increase in market competition and the push by fund sponsors to access additional liquidity. In addition, eligibility criteria have loosened as well, with lenders showing more flexibility to give credit for assets in different jurisdictions and of different types and liquidity profiles than they have in the past.

Asset valuation mechanic

Most NAV facilities feature a robust mechanic relating to the valuation of the collateral, as the assessed value determines the LTV ratio and, by extension, how much the fund can borrow under the facility. NAV facilities typically include valuation challenge rights, where a lender that doubts the accuracy of a sponsor's asset valuation can have a third-party valuation firm provide a second opinion. Historically, lenders had more robust rights to challenge the valuations provided by borrowers, including built-in requirements for third-party appraisals and periodic revaluations. Recent trends show a shift towards more lenient terms, with fewer triggers available to lenders for valuation challenges, shorter timeframes during which lenders may dispute valuations, limitations on the number of times each year that lenders may challenge valuations, and a requirement for a larger gap between the borrower's valuation and the valuation of the third-party appraiser in order for the valuation to be changed and the borrower to be required to pay the cost of the appraisal.

Financial covenants

Unlike subscription credit facilities, NAV credit facilities often incorporate financial covenants and triggers that enable a lender to monitor the overall health of the fund and flag potential trouble early on. These triggers include, in addition to the LTV ratio, minimum net asset value, interest coverage ratios (which assess a fund's ability to generate sufficient cash to pay interest on its debt), and liquidity requirements (which require a fund to maintain a minimum amount of cash and cash equivalents at all times). As the market has become more competitive, lenders have loosened some of these tests and given up others entirely.

Collateral and borrowing base

The primary collateral for NAV financings is the fund's portfolio of investments, which can include equity stakes in portfolio companies, real estate holdings, or other assets depending on the fund's strategy. Lenders have optionality in how aggressive they want to be in terms of their security interest in the fund assets. Previously, NAV facilities often required more onerous collateral packages, including direct pledges of investments, equity in portfolio companies and intermediate holdings companies, and distribution proceeds from investments. Recent trends show a shift towards more lenient terms, with lenders accepting a lighter collateral footprint and more flexible structures, including, in some cases, only a security interest in the cash flows generated by the investments or, in some cases (such as preferred equity NAV financings), no collateral at all.

Amortisation and cash sweep

Because the primary source of repayment for a NAV facility are the assets of the fund, almost all NAV facilities require that, if such assets are sold or otherwise disposed of, the proceeds of that disposition are used to pay down the facility. As market competition has increased, some lenders have loosened these cash sweep requirements. In some cases, lenders have agreed to, among other things:

- looser financial thresholds before cash sweeps are triggered;
- reduced frequency of cash sweeps (for example, on a monthly or quarterly basis rather than immediately upon receipt of proceeds);
- additional carve-outs of certain types of income or proceeds from the cash sweep;
- longer cure periods to address any breaches of financial covenants before cash sweeps are triggered; and
- a right for the borrower to cure financial covenants by contributing equity to the fund in order to avoid triggering a mandatory prepayment or cash sweep.

PIK (pay-in-kind) interest

The option for borrowers to pay interest "in kind" (ie, to add the interest to the principal balance rather than paying it when due in cash) has also become more common in NAV credit facilities over the past year. This option is attractive for borrowers because it enables them to use the entirety of the amount borrowed under the NAV facility instead of holding back some cash in reserve to make interest payments. While lenders sometimes require fund borrowers to use their initial borrowing under a NAV term loan to fund an interest reserve account (and require such account to be replenished from time to time), lenders are increasingly open to reducing the amount of cash that must be kept in such account or giving up this requirement entirely.

Control of cash flows

Most NAV facilities capture the flow of cash from the underlying fund assets through a combination of a security interest, deposit account control agreement, and covenants relating to investment proceeds. NAV lenders are highly focused on the flow of cash from investments because that cash is their ultimate source of repayment. Accordingly, NAV facilities typically include covenants requiring that all proceeds from fund investments (or, in some cases, only proceeds from "eligible investments") are deposited in a cash collateral account over which the bank has a perfected security interest.

As the NAV lending space has become more competitive, lenders have loosened the level of control that they require with respect to these cash flows. Recently, more lenders have allowed borrowers to direct cash flows from controlled accounts rather than providing for a "full block" on the account in favour of the lender from day one.

Guarantees

Given the uncertain value of many of the fund assets against which NAV lenders extend credit and the potential difficulty of liquidating such assets, NAV lenders often require entities that are related to the borrower to guarantee the facility. These guarantees can come from affiliated entities, including general partners, management companies, parent companies, other affiliated funds, and sometimes the individuals that own and control the management company. As the market has become more competitive, many lenders are requiring guarantees from fewer entities, if any, and sometimes agree to limited recourse guarantees tied to bad acts by the sponsor (a "bad boy guarantee") or certain narrowly defined breaches (for example, in a real estate context, an environmental indemnity or the failure to complete a construction project), or "partial recourse" guarantees that cover only a portion of the amount owing under the NAV facility.

Press Coverage of NAV Facilities

In the past year, there were a significant number of articles in the US and UK press (including The New York Times, The Wall Street Journal, and the Financial Times) about NAV facilities. The press coverage tended to focus on the following points:

- discussions about transparency in the use of NAV facilities, with suggestions that there be greater disclosure and communication between sponsors and their investors;
- analysis of the impact of NAV facilities on fund performance; some commentators have focused on the use of NAV facilities to finance distributions to investors prior to the sale of assets, thereby increasing the fund's DPI (Distributions to Paid-In Capital) ratio, a performance metric used to measure the cumulative distributions paid to investors relative to the capital they have invested; and
- conversations about whether and to what extent funds should use NAV loans to leverage their investments.

The ILPA Guidance for NAV Facilities

On 25 July 2024, the Institutional Limited Partners Association (ILPA) released guidance for fund sponsors and investors on NAV facilities. ILPA's goal in releasing the guidance was to standardise practices and improve communication between investors and fund sponsors regarding the use of this product. Some of the key points in the guidance were the following:

- LP Disclosure: ILPA noted that investors may need more clarity on the use of NAV facilities, the impact of these facilities on fund performance metrics, and the effect of using NAV facilities to cross-collateralise fund investments.
- Transparency and Engagement: ILPA advised fund sponsors to obtain investor advisory committee consent before putting a NAV facility in place unless the fund's limited partnership agreement (LPA) explicitly permits a NAV facility. ILPA suggests that sponsors should provide detailed disclosures to investors about the facility's rationale, size, and terms.
- Legal Documentation Proposals: ILPA recommended that new LPAs explicitly authorise NAV facilities and provide for disclosure to investors of and, where appropriate, require LP consent to these facilities. This includes defining "NAV-based facility" in the LPA and

considering whether downstream special purpose vehicle (SPV) leverage should be included in fund-level debt calculations.
- Disclosure Recommendations: ILPA recommended that (i) fund sponsors offer standardised disclosures to investors about the rationale, key terms, and other potential effects of NAV facilities and (ii) investors engage with sponsors to better understand these facilities.

The Market's Response

In response to the ILPA guidance, press coverage, and LP attention to the use of NAV facilities, many of ILPA's recommendations have practically been implemented even though standard fund documentation is still evolving with respect to ILPA's drafting recommendations. Most experienced NAV lenders require that the general partner of the fund borrower disclose the NAV financing to investors and, if the fund has an investor advisory committee or is a fund-of-one or separately-managed account (SMA), obtain consent from the applicable investors for the entry into the facility.

Implications of ILPA Guidelines and Market Attention on NAV Credit Facilities

As a result of this attention to NAV financing, the one feature of NAV credit facilities where increased competition has generally not loosened loan provisions are covenants regarding the use of proceeds. In fact, provisions around the use of proceeds have generally tightened over the past year.

Recent changes to use of proceeds provisions in NAV facilities include:

- Specific Use Restrictions: Lenders are imposing more detailed restrictions on how loan proceeds may be used, often limiting their use to specific purposes such as refinancing existing debt, funding follow-on investments, or covering operational expenses. It is not uncommon for lenders to incorporate a Sources and Uses spreadsheet into the credit agreement documentation reflecting in detail how the proceeds of the NAV loan will be used.
- Enhanced Monitoring: There is a greater emphasis on monitoring and reporting requirements related to the use of proceeds from NAV facilities, with credit agreements now requiring borrowers to report back to their NAV lender shortly after the loan is funded to confirm that the proceeds were used as required under the credit agreement.
- Restrictions on Distributions: Restrictions in NAV facilities on fund distributions to investors, regardless of whether such distributions are funded with loan proceeds or not, have tightened significantly.

Conclusion

NAV financing has emerged as a valuable tool for private investment funds, particularly given the challenging environment for exiting investments over the past year. Increased levels of competition in the NAV lending market have driven a general loosening of key terms in NAV facility documentation, with the exception of provisions relating to the use of loan proceeds and the making of distributions to investors. Those provisions have tightened as a result of attention to NAV facilities by the press, ILPA, and investors. By understanding these trends in the negotiation and documentation of NAV facilities, fund managers (i) can make informed decisions about the use of this product and (ii) if they choose to put in place a NAV facility, can negotiate the financing with an awareness of the pressure points to look for in term sheets and facility documentation.

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