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Cross-Border Marketing: Do Regulators Accept "License Borrowing"?

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This article demonstrates that one of the largest hurdles our alternative investment fund manager (AIFM)/asset manager clients face when fundraising cross-border in foreign jurisdictions is the "licensing challenge."

*The following article, from Cathy Brand (pictured), CEO of **Sales Road Maps Online Ltd.®**, a business that provides guidance on compliance and strategy in the financial world. (We have carried material from the firm, **before**.) This article considers the cross-border issues that arise in marketing funds, taking up the case of Canada. The editors of this news service are pleased to share these insights; the usual disclaimers apply to views of outside contributors. Jump into the conversation, and email tom.burroughes@wealthbriefing.com*

One of the largest hurdles our alternative investment fund manager (AIFM)/asset manager clients face when fundraising cross-border in foreign jurisdictions is the "licensing challenge." Clients report that they are confident with fund/product registration/notification procedures with the local regulator in foreign jurisdictions, but the licensing requirements per country frequently create more of a challenge, as well as complexity for AIFMs/asset managers fundraising overseas.

Here's the scenario: Many clients have a principal "regulated entity" registration with the regulator (national country authority) in their home state jurisdiction. The same client has multiple affiliates globally, some of which are not "regulated," meaning that they are not licensed by their local regulator to conduct "regulated activity" in their local jurisdiction.

In this post, we explore the concept of AIFM/asset manager service level agreements ("intracompany SLAs") between affiliates within the same company (aka "license borrowing") and how NCAs treat this practice.

Do NCAs accept "license borrowing" among a company's affiliates to carry out regulated activities in their jurisdiction? In our Canada case study, we examine how this concept plays out for cross-border AIF marketing into Canadian provinces.

Is cross-border fund marketing a "regulated activity"?

Yes.

Marketing funds cross-border constitutes a regulated activity in each jurisdiction. This is why there are regulations in each country governing the promotion of financial products or services to investors in that country. Compliance with country fund marketing regulations is not optional.

Cross-border marketing compliance comprises a "two-track investigation" before commencement of marketing activity:

1. ***Fund requirements:*** Do we need to register/notify/make any fund filings with the regulator to market our fund in that country? Or can we operate under a fund registration exemption?

2. ***License requirements:*** Do we need a license or license registration in order to market funds in that jurisdiction? Or can we operate in under a license exemption?

Cross-border marketing key (and sometimes forgotten) requirement: Licensing

All too often, licensing requirements for cross-border marketing are overlooked by AIFM/asset managers. Because "marketing" is a regulated activity, regulators require the entity marketing into their jurisdiction to have a license to conduct the marketing and/or to operate in their jurisdiction under an exemption from the requirement to register for a license.

Regulators across the globe are cracking down on breaches of their country's regulations through enforcement against a wide range of activities, including breaches of their laws for marketing financial products (funds) to investors in their country.

What is "license borrowing"?

The scenario goes like this:

Bob and Susie, sitting in our US Registered Investment Advisor affiliate in the US, want to market our AIFs (private funds) cross-border into Canada because they have Canadian investor contacts. Our US affiliate is not licensed to conduct "dealing activities" (fund marketing) in the US. It is not a licensed broker-dealer.

Clients have asked us, "Can [we] put in place a service level agreement between our regulated affiliate (i.e., our UK FCA-licensed affiliate which is licensed to market funds in the UK) and an unregulated affiliate (i.e., US RIA affiliate that is not licensed as a broker-dealer) so that US sales teams can conduct cross-border marketing into jurisdictions which require all marketing to be conducted by a regulated/licensed entity?"

"License borrowing" (intracompany SLAs) seems like a simple compliance paper trail solution. However, in substance this practice does not pass the regulatory compliance "smell test" and severely underestimates regulators' intelligence … and competence.

To understand why, AIFMs/asset managers need to understand the concepts of marketing compliance form vs. substance.

Country licensing regulations (marketing): Form vs. substance

Marketing compliance "form" comprises books, records, and evidence that AIFMs/asset managers put into their compliance files to document compliance with marketing regulations in each jurisdiction where they are doing business. If you put in place an SLA between a company's two affiliates – affiliate A (unregulated) and affiliate B (regulated) for A to carry out regulated activities under B's license (aka borrowing another affiliate's license) – this is an attempt by the AIFM as marketing compliance "form" or a proof check.

Marketing compliance "substance" means that it matters to the regulator that your actual activities in any foreign jurisdiction comply with the country's marketing rules in "real time." It is an honesty check.

If your affiliate A (unregulated) is the entity carrying out the regulated activity in any jurisdiction under a borrowed license from regulated affiliate B, then this is the "substance" of your licensing compliance.

Why do regulators care if we have intracompany SLAs between our affiliates within the same company so that we can conduct regulated activities cross-border through license "sharing"? It's all the same company….

Regulators apply both a "substance test" and a "form test" to determine if you are compliant with their country's regulations. Regardless that both affiliates are within the same company, regulators will require your form to match your substance.

If an affiliate requires a license to conduct cross-border marketing into other countries, then the unlicensed affiliate cannot just "borrow" another regulated affiliate's license and say to the regulator, "We've met the license requirement: here's our intracompany SLA to prove it."

Regulators will look through your form to examine the substance of your activities in their jurisdiction. It's called "piercing the veil to see your substance." That is, scrutinizing the façade of the form to see what you're doing in reality.

License borrowing case study: Canada

Canada's fund marketing regulations apply per Canadian provinces (10) in which the cross-border marketing is taking place. Due to its proximity to the US, Canada is a popular jurisdiction for US AIFMs and/or global AIFMs with a US SEC-licensed affiliate to conduct cross-border AIF marketing because Canada is "right next door" to the US.

Just like the example above with Bob and Susie employed by a US RIA, there are many RIAs based in the US who want to market their "private funds" cross-border to investors resident in Canadian provinces. Many of these US RIAs don't have a US affiliate that is a licensed broker-dealer which they can use for the purposes of cross-border marketing into Canada.

How to market cross-border into Canada

If you want to market your fund to investors in Canada (or conduct "dealing in securities" in the Canadian provinces), one of the most popular license exemption options is to operate under the "International Dealer Exemption" ("IDE"). To avail yourself of the IDE, the entity conducting the marketing into Canada has to have a license to market funds in their own jurisdiction in order to qualify for the license exemption under IDE.

Canada (Ontario) Counsel confirms the following scenario is a breach of Canadian regulations: US RIAs (Bob and Susie in the US) who do not have the license to qualify to operate under the IDE into Canadian provinces "borrow" the license of their other company affiliates which are licensed to market funds (i.e., UK FCA license), use the UK license to apply for the ID exemption and then Bob and Susie market the funds into Canada from the unlicensed RIA in the US.

You can't "paper trail" your Canadian compliance program with an intracompany SLA. These agreements are not recognised by Canadian regulators such as Ontario Securities Commission (OSC).

So, the answer is NO, Canadian regulators do not accept or recognise "license borrowing" to operate cross-border under IDE in Canada.

Summary

Regulators are not asleep or naïve. On the contrary, NCAs are on to market players who breach their licensing regulations and they are aware of practices intended to circumvent licensing rules through "license borrowing" (intracompany SLAs).

Regulators expect that if you say you are compliant with their country fund marketing regulations, your marketing compliance "form" must match your marketing "substance" at all times. Be prepared at any time for NCAs to "pierce the form veil" and examine the substance of your activities in their jurisdiction.

Hoodwinking regulators is not advised!