

Hedge funds in Armenia: regulatory overview

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MARKET OVERVIEW

1. What is the structure of the hedge funds market? What have been the main trends over the last year?

The Law of Armenia on Investment Funds (Investment Funds Law) was adopted on 22 December 2010 and has been in effect since 9 January 2011. The Investment Funds Law allows for a fund with additional risk (hedge fund) as a qualified investors' fund and type of specialised fund, which can be established and act in Armenia. However, the Armenian investment fund market is still in its infancy, and the vast majority of investment funds (among which none were hedge funds), were established in 2017.

To our knowledge, no hedge fund has been established in Armenia as at April 2018.

REGULATORY FRAMEWORK AND BODIES

2. What are the key statutes and regulations that govern hedge funds in your jurisdiction? Which regulatory bodies regulate hedge funds?

Regulatory framework

The main law regulating investment funds is the Investment Funds Law, which allows for the establishment of open-ended and closed-ended investment funds in Armenia. The following regulations govern hedge funds:

- Decision of the Board of the Central Bank of Armenia (CBA) on the determination of the minimum value of a fund's and sub-fund's net asset value.
- Regulation 10/11 on Registration of Investment funds, procedure and condition for granting preliminary permission on trading of securities of foreign investment funds in Armenia, approved by the CBA.
- Regulation 10/06 on minimal requirements of the control and risk management system of the Manager of the Investment funds, approved by the CBA (applicable to the public investment funds).

Regulatory bodies

The CBA is the main regulatory body for the hedge funds market in Armenia.

3. How are hedge funds regulated (if at all) to ensure compliance with general international standards of good practice?

Risk

According to the Investment Funds Law, a hedge fund manager must establish a risk management system equipped to supervise

and assess the fund's risk position and the share in the total risk of the portfolio. The manager must establish a process that will ensure a proper and independent assessment of the value of derivative financial instruments circulating in the unregulated market.

The general rule relating to net asset value for retail investment funds (that is, ensuring that the total risk associated with the derivative financial instruments in which the fund's assets have been invested do not exceed the fund's total net asset value) does not apply to hedge funds.

Valuation and pricing

The fund manager decides on the initial offering price of the shares of a fund and underwrites the first placement of its shares. Afterwards, the shares are underwritten, and the underwriting price of the shares are published on the day a purchasing (underwriting) request is made, except for close-end and time-ranged funds (where the price should be published at least once a month).

Systems and controls

Management of fund and custody of asset portfolio of fund must be provided by two different entities that are not connected by affiliation, which means that:

- One must not directly or indirectly own, by virtue of voting right, 20% or more of equity securities carrying voting rights of the other (or others);
- More than half of the members of the board of directors of either entity, or director or other related official with such competencies must not, at the same time, also be a member of the board of directors of the other entity (or others), or director or other related official with such competencies.
- One must not be a subsidiary of the other, or be under common supervision (subsidiaries of the same company), or one of them, in accordance with criteria prescribed by regulatory legal acts of the Central Bank of Armenia, must not have any actual opportunity or opportunity prescribed by contract, to essentially influence the decisions of the other.
- They must not be members of the same family or have been acting in concert in a given situation, upon a common economic interest;

The manager of the fund should establish an internal audit and risk control system.

Insider dealing and market abuse

The general rules on the prohibition of insider dealing and market abuse as set out in the Law of Armenia On Securities Market (Securities Law) are also applicable to the hedge funds. Therefore, there is no specific regulatory regime for insider dealing and market abuse applicable to hedge funds.

Transparency

With the exception of qualified investors' funds (which are different to regular funds), fund managers must publish their financial reports (annual and intermediate reports) for the Central Bank of Armenia (CBA).

However, when specifically requested to do so, all funds (including qualified investors' funds) must prepare and submit financial reports to the CBA.

Money laundering

Under the Law on Combating Money Laundering and Terrorism Financing (AML/TF Law) investment fund managers fall within the scope of a "reporting entity". As a reporting entity, a fund manager must:

- Establish and apply internal Know-Your-Customer procedures.
- Identify and assess the fund's potential and existing anti-money laundering or terrorist financing risks, and establish policies, controls and procedures that enable them to effectively manage and mitigate identified risks.
- Report any non-cash transactions above AMD20 million or cash-related transactions above AMD5 million to the Financial Monitoring Centre (FMA) of the CBA.
- Report suspicious transactions or business relationships to the FMA of the CBA.

Short selling

According to the Investment Funds Law, hedge funds can form their assets mainly through either/both:

- Issuing an unlimited amount of loan and using derivative financial instruments.
- Selling assets that the fund does not possess at the time of the transaction (short sale).

No further details or rules concerning short sales are set out in the Investment Funds Law or other regulations.

MARKETING

4. Who can market hedge funds?

Onshore hedge funds

Management of a fund can include the management of investments, which includes the organisation of offerings and underwritings of the fund's shares (marketing)) (for details of a hedge fund manager's functions, see *Question 9*). The marketing of a hedge fund is therefore carried out by the fund manager.

In relation to the marketing of hedge funds in Armenia, it should be noted that any advertisement, announcement about any type of fund or any action directed towards the offer and/or sale of a fund's shares, document or means of communicating information relating to the fund must include a clearly visible statement, that is separate from the other information, stating that the fund and its manager cannot guarantee the fulfilment of purposes declared by the fund.

When making any such marketing announcement, the fund manager is prohibited from:

- Making any misleading assumptions and statements in relation to the fund.
- Giving guaranties in relation to the fund.
- Making any unjustified/misleading promises in relation to the fund.

- Using unfair competition methods.

Management of a hedge fund can include the management of investments, which generally implies:

Offshore hedge funds

Not applicable.

5. To whom can hedge funds be marketed?

Onshore hedge funds

For funds that are qualified investors' funds, the fund's shares/units can only be offered to:

- Qualified investors.
- Investors who have individually purchased shares that have a greater value (in each offering the total value of shares being purchased) than the value set by the regulations of the Central Bank of Armenia (CBA).

To be a "qualified investor", the investor must qualify as one of the following:

- Investment companies, branches of foreign investment companies, banks, credit organisations, insurance companies, investment, pension funds and managers of investment companies, as well as legal persons registered in foreign states, which, pursuant to the legislation of the given state are entitled to carry out the activities of any person defined in this bullet point.
- The state of Armenia, the communities of Armenia, the CBA, foreign states, local self-government bodies of foreign states, central banks of foreign states.
- International financial organisations, including the International Monetary Fund (IMF), European Central Bank (ECB) and the European Investment Bank (EIB).
- Person considered to be qualified investors by law or regulatory legal acts of the CBA, based on the knowledge and experience of the given person in financial sector, his/her ability to hire specialists with relevant knowledge and experience, the amount of his or her net assets or the amount of assets under his or her management and other similar criteria.
- Legal persons, the participators (the investors/shareholders, unit holders) of which are persons listed above.

The securities of foreign funds can be sold in Armenia if the CBA has issued a preliminary authorisation for them. However, the sale of such securities must be made through an agent (apart from in cases where the securities are sold by a branch of the hedge fund manager established in the territory of Armenia by a manager operating in Armenia or a foreign manager).

Offshore hedge funds

Not applicable.

INVESTMENT RESTRICTIONS

6. Are there any restrictions on local investors investing in a hedge fund?

Generally, there are no legal restrictions on investing into hedge funds in Armenia.

ASSETS PORTFOLIO

7. Who holds the portfolio of assets? What regulations are in place for its protection?

The assets of the fund must be transferred to a custodian under a custody contract. A custodian can be the Central Depository or a bank operating in the territory of Armenia, which pursuant to the Law of Armenia On Securities Market (Securities Law) provides securities custody services. Custody of assets of a single fund can only be taken by a single custodian, personally or through sub-custodian (sub-custodians).

For the protection of the assets, the Investment Funds Law sets out the following rules in relation to the custodian:

- The custodian must not be affiliated with the fund manager. During the period of the custody contract, the manager and the custodian should take reasonable measures to prevent circumstances leading to affiliation between themselves, and if such circumstances arise, deal with them within six months.
- If the custodian finds any violation of the requirements of the law, regulations and/or the fund's rules while implementing its responsibilities, it must inform the Central Bank of Armenia (CBA) and the fund manager of the violation in writing within one working day.
- The custodian must take responsibility for causing any damage (including lost income) to the manager or fund or to the shareholders of the fund that had resulted from its actions or inaction (unless it can prove that it acted within its fiduciary duties). Meanwhile, the fund manager can directly or indirectly bring a claim for remedying the damages caused to the fund or its shareholders.
- When carrying out its obligations, the custodian must act in accordance with the interests of fund's shareholders, and should implement its rights and fulfil its obligations towards the fund's shareholders in good faith and reasonably and adequate level of professionalism (fiduciary duty).
- The contract signed between the fund (or fund manager of a contractual fund) and the custodian must not limit the responsibilities of the manager set out in the Investment Funds Law and/or other laws.

Unlike of other types of funds, the content of the custody contract for qualified investors' funds will not be subject to the CBA's review and control.

REQUIREMENTS

8. What are the key disclosure or filing requirements (if any) that must be completed by the hedge fund?

When registering a qualified investors' fund (and other hedge funds), the following must be submitted to the Central Bank of Armenia:

- Application form (the register the fund and the name of the fund).
- Resolution of the founders' meeting establishing the fund (in the case of a corporate fund).
- The fund manager's board decision to found and manage the fund (not applicable if a corporate fund is being founded, which is not on the initiative of the manager).
- Draft of the fund's rules (sometimes referred to as the fund's "charter").

- Decision to approve the fund's rules (in the case of a contractual fund).
- Draft of the fund management contract that was presented by the manager and approved at the founders meeting (decision of the founder).
- Fund's custody contract that was presented by the custodian and approved (in the case of a corporate fund) at the founders meeting (decision of the founder).
- Decision of the founder (founders' meeting) (in the case of a corporate fund) or fund's meeting (in the case of a contractual fund, whose rules do not envisage that in that fund a fund meeting will not be called) on approving the fund's rules and the draft custodian contract.
- Receipt on payment of the state duty.
- Data about the person acting as executive of the fund.

In contrast to other funds, qualified investors' funds are not required to submit a prospectus to the CBA (among other documents) when submitting its registration package.

9. What are the key requirements that apply to managers or operators of hedge funds?

Onshore hedge fund managers

Management of a hedge fund must be provided by a hedge fund manager. A hedge fund can have only one hedge manager, but hedge manager can manage more than one fund (however, contractual funds managed by the same manager can differ with regards to type, investment policies, rights certified by the shares of participants and/or limitations on the circle of fund's participants).

A hedge fund acting in Armenia can be managed by a local manager (joint stock company or limited liability company established in Armenia), a local subsidiary of a foreign manager, or by local branch of foreign manager.

Management of a fund can include the management of investments, which generally implies:

- The adoption and execution of decisions concerning the investment of the fund's assets within the investment policy of the fund.
- The organisation of the issuance and repurchase (redemption) of shares.
- The organisation of legal and accounting functions in connection with the management of the fund.
- The organisation of offerings and underwritings of shares (marketing).

To act as a fund manager, a local company or subsidiary/branch of foreign manager should be registered and licensed by the Central Bank of Armenia (CBA).

The business activities of fund managers are limited: any activities other than the managing of fund should only relate to the securities market and can only be implemented subject to the CBA's permission.

The fund manager should comply with requirements in relation to (among other things):

- Its qualified and certified top management.
- Minimal amount of charter capital (that is, capital the founders put into the fund when first established) and total capital.
- Its reporting obligations to the CBA.
- Its business plan for each three-year period.

- The establishment of an internal board and systems of internal control.
- Participation rate in managed funds.

The fund manager should register any of the following changes to the CBA:

- Any change to the charter of subsidiary/branch of foreign manager or manager.
- Any change to its top management.

Offshore hedge fund managers

Not applicable.

LEGAL FUND VEHICLES AND STRUCTURES

10. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures?

Contractual fund

Advantages. The advantages to using contractual funds are as follows:

- There is no requirement to register a company, only the fund's rules (fund management contract), therefore the group of assets can be pooled by using a contractual investment fund management contract.
- Contractual funds can be established as open-end, closed-end or time-ranged funds, and can be either public or non-public (with no more than 49 shareholders).
- Contractual funds can be divided into sub-funds.
- The assets of the contractual fund, the securities, other property and its rights acquired through those assets, can be separately recorded and registered in the name of the fund manager, without the manager acquiring ownership rights. By investing assets into a contractual fund, the shareholder ceases his/her title toward the fund he/she purchases the title of common ownership toward the assets of the fund.

Disadvantages. The disadvantages to using contractual funds are as follows:

- The ownership rights of shareholders of a contractual fund towards the fund's assets is limited to disposals (sale) transfer on the basis of succession, receiving dividends from income derived from the management of the fund's assets, as well as the right to receive their share from the fund's assets in case of its cessation.
- The ownership right of a closed-ended fund shareholder entails participation and voting in fund meetings unless the fund's rules specifically provide that no fund meetings need to be called.
- There may be obligations under the contract which must be concluded where there has been a violation of fund's rules by the fund manager.

Corporate fund

Advantages. The advantages to using corporate funds are as follows:

- Flexibility of entity. Corporate funds can be established as a legal entity and can take the form as either a joint stock company (both with a fixed or a floating capital) or a partnership founded on a trust. Corporate funds can be public or non-public (with the number of shareholders in non-public funds being limited to no more than 49 shareholders). Joint

stock companies (with either fixed or floating capital) cannot, however, be established as non-public funds.

- There is no requirement to establish a board of directors or advisory committee for a corporate fund.
- Corporate funds do not need to create a reserve capital.

Disadvantages. The disadvantages to using corporate funds are as follows:

- Corporate funds established as a joint stock company with a fixed capital or a partnership founded on trust can be only a closed-end or time-ranged fund. Time-ranged corporate funds whose rules require the repurchase time range more than once per year, cannot be a joint stock company with a floating capital.
- The shareholder only owns title toward the shares of fund.
- A joint stock company corporate fund can only issue ordinary registered shares.
- There is no option to establish sub-funds.

TAX TREATMENT

11. What is the tax treatment for hedge funds?

Funds

According to Armenian tax law, the seat of an investment fund established in Armenia will be the seat of its fund manager. For all matters in relation to the payment of taxes, the fund manager acts on behalf and on account of the investment fund that he/she manages.

Investment funds are subject to income tax. The tax base for the calculation of income tax is the total amount of the fund's net assets established in Armenia calculated according to rules established by the Armenian tax authorities and the Central Bank of Armenia (CBA) (no deductions from the sum distributed to shareholders as dividends are permitted while determining the tax base). The income tax rate for investment funds is 0.01% from its tax base.

The following transactions are not subject to VAT:

- The provision of services for the allocation and/or buyback (redemption) of securities issued by investment funds.
- The provision of investment fund custody services.
- The disposal (sale) of real estate to the shareholders of a fund where that shareholder had invested in exchange for shares in fund.

It is prohibited to make a loan of either the accounts or cash of the fund.

Resident investors

Investment from a natural person into a fund, along with the profit received from the sale of securities that make up a fund, will not be considered a disposal subject to the calculation of profit tax.

Expenses related to the purchase, sale or other activities related to the shares of funds are not considered expenses for the calculation of income tax base for legal entities. In addition, income received from securities of funds are not considered income.

Non-resident investors

No tax is applicable to non-resident investors in Armenia.

RESTRICTIONS

12. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

Redemption of interest

In general, redemption of interest is allowed. However, depending on the type of fund, different rules will apply.

The shareholder of an open-ended fund can make a demand for the repurchase of shares on any given business day. The redemption of time-ranged fund's shares must be performed according to the time frame stipulated in the fund's rules (no less than once a year). The shareholder of a close-ended fund can demand for a redemption of shares where he/she has voted against a merger of fund, or voted against changes and amendments that limit their rights or have not participated in the voting process for that particular issue.

Repurchased shares do not provide any voting rights, cannot be accounted for during counting of the votes, as well as in the calculating value of the shares. In addition, no dividends can be paid against repurchased shares. The repurchase (redeemed) share cannot be resold and will be subject to redemption only.

The Investment Funds Law also determines the cases where redemptions are not permitted. Repurchase (redemption) of shares is not permitted when:

- There is no manager or custodian.
- The manager or custodian is bankrupt and or are being liquidated.
- The fund is in the process of discontinuation (liquidation).

Transfer to third parties

The shareholders of the fund (apart from funds that have the organisational status of a partnership founded on trust) do not have preference rights on newly issued shares.

The rules of a closed-end fund cannot restrict the right of the shareholders to sell their shares on regulated markets. However, the shares of closed-end funds are subject to mandatory authorisation before they can be sold on a regulated market.

PRIVATE PLACEMENT

13. Are private placements of hedge funds permitted under national private placement rules in your jurisdiction?

The shares of a non-public fund cannot be placed publicly, which includes a ban on the offering of shares of non-public funds solely to an indefinite number of qualified investors.

In other cases (establishment of public funds), the shares of the fund can be subject to public placement.

14. What are the requirements for making a private placement of hedge funds?

Essential requirements to qualify for the regime

There are no specific requirements in the Investment Funds Law or associated regulations concerning qualification for the regime of private placement in relation to hedge funds. There are, however, some general rules regulating the placement of shares concerning the determination and calculation of price of shares, cases of suspension and banning of placement of shares.

The number of shareholders of non-public funds cannot exceed 49.

Registrations/permits/licences

No additional registration/permit/licence is required.

Documents to be filed

No special rules concerning document stipulated in the Investment Funds Law or the associated regulations.

Regulatory timescales

No special rules established.

Registration/permit/licence fees

Initial fees. No special rules established.

Ongoing fees. No special rules established.

Content requirements for offering memorandum

No special rules established.

Restrictions on investments/leverage

No special rules established.

Requirements for local service providers

No special rules established.

Requirements for non-local service providers

No special rules established.

Requirements for directors

No special rules established. The fund must be managed by a licensed manager who must be registered and certified by the CBA.

Ongoing filing/consent requirements

No special rules established.

Other

Not applicable.

REFORM

15. What (if any) proposals are there for the reform of hedge fund regulation?

To the best of our knowledge, there is no proposed or upcoming draft or legal amendment due in relation to retail investment funds.

The recent amendments to the Investment Funds Law, which passed their first reading at the National Assembly of Armenia, were related to securitisation funds only.

ONLINE RESOURCES

Armenian Legal Information System

W www.arlis.am

Description. The Armenian Legal Information System website contains Armenian legislation. It is updated and supported by the Public Bulletin CJSC. No translations of laws and regulations are available.

Central Bank of Armenia

W www.cba.am

Description. Provides categorised laws and regulations as well as translations for them (it should be noted that not all of them are up-to-date).

Practical Law Contributor profile

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Publications

- *Authored the article "Warranty: a Rescue or a Trap?" published in AmCham Business Magazine Spring-summer 2014.*
- *Analysis of the Company Law published in International Trust Laws and Analysis, Supplement 2018-1.*
- *Doing Business in Armenia published in Practical Law Global Guide 2016/17.*
- *Mergers and Acquisitions 2016 published in ICLG.*
- *Litigation and Dispute Resolution 2017 published in Global Legal Insights.*
- *Armenia - Data Protection in the Financial Sector Guidance Note as an expert contributor to Data Guidance, the global privacy platform in 2017.*