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The International Comparative Legal Guide to:

Alternative Investment Funds 2015

3rd Edition

A practical cross-border insight into Alternative Investment Funds work

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1 Regulatory Framework

1.1 What legislation governs the establishment and operation of Alternative Investment Funds?

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.

Within Europe, London currently dominates the hedge fund market, both in terms of the number of fund managers and by share of hedge fund assets. Unlike in the context of many private equity, real estate and infrastructure funds, where both the fund manager and the fund itself tend to be domiciled in the UK, a classic hedge fund structure in the UK would not include the actual hedge fund being domiciled in the UK. Instead, hedge fund structures will invariably include an off-shore company or off-shore limited partnership established in a jurisdiction such as the Cayman Islands. A UK entity would then be appointed as the discretionary investment manager to, or investment adviser of, the hedge fund.

Prior to the Alternative Investment Fund Managers Directive (AIFMD), supplemented by its Level 2 Delegated Regulation (Delegated Regulation) and guidelines from the European Securities Markets Authority (ESMA), the framework for Alternative Investment Funds was derived from the Financial Services and Markets Act 2000 (FSMA) and the principal regulatory authority, the Financial Conduct Authority (FCA). However, AIFMD has ushered in a new regulatory environment for many investment fund managers, including private equity firms and managers of hedge funds.

AIFMD offers the lofty ideal of pan-European harmonisation of the regulatory and supervisory framework for the non-UCITS (undertakings for collective investment in transferable securities) fund sector, together with the associated freedom to passport management and marketing activities on a cross-border basis. However, no passport is ever free and for Alternative Investment Fund managers (AIFMs) there will be significant costs and burdens; and in common with other Directives, the creation of freedoms within Europe can come at the price of newly erected barriers to truly international business.

As noted above, AIFMD applies to the non-UCITS sector. Broadly speaking, UCITS funds have not been used to implement alternative investment strategies and therefore are generally outside the scope of this chapter. Some hedge fund managers may be able to launch products under the UCITS brand if the proposed investment strategy fits into the framework and the UCITS requirements will offer investors greater regulatory safeguards and protections. However, the fact that UCITS funds are subject to mandated investment and borrowing powers means that they are likely to lack the investment flexibility which is available to private funds.

AIFMD has been implemented in the UK by various implementing measures – primarily the Alternative Investment Fund Managers Regulations 2013 (SI 2013/1773), the Alternative Investment Fund Managers (Amendment) Regulation 2013 (SI 2013/1797) and the Alternative Investment Fund Managers Order 2014 (SI 2014/1292). The majority of these implementing measures have been introduced by way of updates to the FCA Handbook. The FCA created a new investment fund sourcebook, called "FUND", as part of its Handbook and this contains most of the FCA's rules and guidance for UK AIFMs, which adds an additional component to the general regulatory framework set out under FSMA.

The European Venture Capital Funds Regulation (VCF Regulation) provides what is essentially "AIFMD Lite" for EU venture capital fund managers.

1.2 Are managers or advisers to Alternative Investment Funds required to be licensed, authorised or regulated by a regulatory body?

In the UK, only appropriately authorised persons can carry on a regulated activity by way of business. It is a criminal offence to breach this requirement. Any agreement entered into by a person carrying on a regulated activity in contravention of this provision is unenforceable against the other party and the other party is entitled to recover any money paid and to compensation for any loss sustained.

Many Alternative Investment Funds will be AIFs for the purposes of AIFMD. An AIF is a collective investment undertaking which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors. Even if a vehicle does not fall within the definition of an AIF, it may be categorised as a collective investment scheme (CIS) under FSMA (a CIS is similar, but not identical, to the European concept of a collective investment undertaking). An example of this is likely to be carried interest arrangements structured through a limited partnership, which are unlikely to be AIFs due to the employee participation scheme exclusion from AIFMD, but which are likely nevertheless to be an unregulated CIS for the purposes of domestic legislation.

The FCA authorises and regulates persons carrying out specific "regulated activities" in the UK. Acting as the manager of an AIF is a regulated activity, as is establishing, operating (which includes managing) and winding up an unregulated collective investment scheme. A suitably authorised person must therefore be appointed to carry out these activities on behalf of an Alternative Investment Fund.

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AIFMD contains a partial exemption for AIFMs whose total assets under management do not exceed certain thresholds. These sub-threshold firms will not have to comply with the full provisions of AIFMD, unlike those firms which are "full-scope" AIFMs. The relevant thresholds are: (i) €500 million, provided the AIF is not leveraged and investors have no redemption rights for the first five years; or (ii) €100 million (including assets acquired through leverage). The exemptions do not remove the requirement for authorisation and sub-threshold firms will need to apply to the FCA to become a "small authorised AIFM" or, in certain limited circumstances, a "small registered AIFM". The latter category imposes the lowest regulatory burden on firms, but is only available for internally managed AIFs and certain types of real estate scheme. Sub-threshold AIFMs can opt into AIFMD to be treated the same as full-scope AIFMs, so as to benefit from the AIFMD passporting regime.

A regulated entity which conducts all of its activities in its capacity as the manager/operator of an Alternative Investment Fund – whether an authorised AIFM or not – will be exempt from the EU Markets in Financial Instruments Directive (MiFID).

Historically though, many UK resident managers or advisers of off-shore hedge funds would have been subject to MiFID as the manager/operator of the fund was off-shore and the UK regulated entity was merely its delegate in respect of relevant investment management services. This analysis though has been somewhat muddied by the "letterbox" test imposed under AIFMD. The consequence of this test is that in some cases the entity which is designated as the manager of an AIF under the fund documentation is not regarded as the AIFM for the purposes of AIFMD (because it is a letterbox). The exact analysis of the letterbox test applicable to any situation is very fact-specific, but the risk is likely to arise from one of the tests set out in the Delegated Regulation which provides that a manager of an AIF is likely to be deemed a letterbox if it delegates the performance of investment management functions (i.e. investment management and risk management) to an extent that exceeds by a substantial margin the investment management functions performed by the manager itself. The consequence of this is that an on-shore manager of a hedge fund may, depending on the exact structure and division of powers, now find itself as the AIFM for the purposes of the Directive even if it feeds its services into an off-shore manager.

1.3 Are Alternative Investment Funds themselves required to be licensed, authorised or regulated by a regulatory body?

Generally speaking, under the current UK framework an Alternative Investment Fund itself is not required to be authorised or licensed by the FCA. AIFMD broadly supports the traditional position that it is the manager (or AIFM) rather than the Alternative Investment Vehicle which is subject to regulation. However, whilst historically there have been very few operational requirements imposed at the level of the fund itself, to the extent AIFMD applies, the AIFM must now ensure that certain requirements are imposed upon the fund, such as: the appointment of a depositary to have custody of certain assets and/or verify title to privately held assets; organisational controls (relating to risk management, compliance and valuation); conduct of business rules (relating to due diligence, execution of orders and reporting); and rules relating to companies in which the fund has a substantial stake.

This will not be the case if the fund manager is looking to implement an alternative investment strategy through a retail fund (meaning those which are approved by the FCA to be marketed to identified categories of investors, including in the case of undertakings for collective investment in transferable securities (UCITS) and non-UCITS retail schemes, the general public) – in this case the fund itself, as well as the manager, would need to be authorised by the FCA.

1.4 Does the regulatory regime distinguish between open-ended and closed-ended Alternative Investment Funds (or otherwise differentiate between different types of funds) and if so how?

The UK regulatory regime, broadly speaking, does not differentiate between open-ended and closed-ended private funds, assuming that the fund is domiciled within the UK, although, as noted above in the context of sub-threshold firms, the partial exemption from AIFMD will bite at a higher level for non-leveraged closed-ended funds.

However, the regulatory categorisation of UK fund managers advising or managing off-shore structures may be different to that which would apply if the entire structure is on-shore.

Other regulatory requirements which might apply to a manager of Alternative Investment Funds are linked with the investment strategy being pursued rather than whether the fund is open-ended or closed-ended (although the relevant strategy might be linked with a particular type of fund). For example, further requirements of UK legislation which are particularly relevant to hedge funds include: rules relating to market abuse and insider dealing; disclosures of interests in shares and related derivatives above certain levels; and disclosures of net economic short exposures to certain financial sector companies and companies subject to a rights issue.

1.5 What does the authorisation process involve?

An application for authorisation under FSMA involves the applicant submitting a considerable volume of information to the FCA. This will include information on the proposed business activities of the applicant, its controllers and individuals who will be undertaking certain core controlled functions, its systems and controls including those relating to the manner in which the applicant monitors its compliance with applicable FCA Rules, its group structure and reporting lines and financial projections for the first year of trading. For those applicants applying for authorisation to manage an AIF, the FCA will require further information about the AIF itself (such as details of the AIF's risk profile and its use of leverage).

Once a complete application has been submitted (together with the requisite application fee), the FCA currently has six months to review the application (this is reduced to three months in the context of applications by AIFMs). During the review process, the FCA is likely to raise additional queries in relation to the information submitted.

Over the course of 2014, the FCA published a suite of forms for use by UK AIFMs in order to apply for the various permissions and authorisations a UK AIFM is required to apply for. Further applications will also need to be made in relation to any "material changes" to the information submitted as part of the authorisation application.

Following authorisation, a successful applicant will need to comply with the applicable conduct of business and prudential rules of the FCA which are relevant to its business. In the context of AIFMs, particular focus is likely to be given to the capital adequacy requirements of, and remuneration principles imposed by, AIFMD.

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1.6 Are there local residence or other local qualification requirements?

A fund manager applying for authorisation under FSMA (whether or not as an AIFM) must meet certain threshold conditions. One of these is that the head office of the applicant must be 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.

1.7 What service providers are required?

Historically, there have been no formal requirements to appoint external service providers to private funds domiciled in the UK (although a manager may have engaged service providers as a matter of choice). However, this is another area of change under AIFMD. One of the most significant changes under AIFMD is the requirement to have a depositary, who will have the responsibilities set out under AIFMD (which include custody, cash movement reconciliations and monitoring certain processes such as issues and redemptions of units and valuations). Independent valuers may also be appointed pursuant to the provisions of AIFMD.

1.8 What co-operation or information sharing agreements have been entered into with other governments or regulators?

One of the key determinants in the context of a non-EEA (European Economic Area) manager's ability to market a non-EEA fund within Europe, will be whether information exchange arrangements are in place between the jurisdiction (i.e. Member State) in which the marketing takes place and the jurisdiction in which the fund manager and the fund itself are established. The information exchanging arrangements the FCA has entered into can be found at http://www.esma.europa.eu/content/AIFMD-MoUs-signed-EU-authorities, but it includes all of the primary fund jurisdictions including the British Virgin Islands, the Cayman Islands, the Channel Islands and the United States.

2 Fund Structures

2.1 What are the principal legal structures used for Alternative Investment Funds?

There are a wide variety of fund vehicles available in the UK. Certain of these are only available for retail funds, such as the authorised unit trust and the open-ended investment company. Others, such as the investment trust company, are likely to be used for closed-ended structures implementing a traditional investment strategy.

However, a private fund domiciled in the UK and implementing an alternative investment strategy will usually take one of two forms. Closed-ended private funds (in particular those investing in asset classes such as private equity, real estate and infrastructure) are most commonly structured as limited partnerships. This is a form of partnership governed by statute under the Limited Partnerships Act 1907.

In common with other jurisdictions, the limited partnership will have one or more general partners and one or more limited partners. The general partner is responsible for the management of the limited partnership (although whether it fulfils this role will largely depend on the regulatory issues described above), but has unlimited liability for the debts and obligations of the partnership over and above the partnership assets. Conversely, the liability of a limited partner will be limited to the amount it contributes to the partnership, provided such limited partner takes no part in the management of the partnership: to the extent the limited partner does take part in management, it will be treated as a general partner and will lose the protection of limited liability. A limited partnership registered in England & Wales does not have any legal personality separate from its partners and is not a body corporate.

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. The constitutional document (the limited partnership agreement) is a freely negotiable document between the fund manager and the investors.

The statutory framework in the UK requires that a limited partnership is registered as such. This entails providing an application for registration to the Registrar for Limited Partnerships, providing certain details including the name of each limited partner and the amount of capital contributed by each limited partner. Any changes to these details during the continuance of the limited partnership must be similarly registered within seven days of the relevant change. There are also formalities that must be followed on assignments of limited partnership interests, such as advertising the transfer in specific publications.

It is also possible for a private closed-ended fund in the UK to be structured as a unit trust. 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, in addition, strict fiduciary duties are owed by the trustee as a matter of law.

As noted above, although the UK is the primary European hedge fund centre, the usual hedge fund structure will generally not include the actual hedge fund being domiciled in the UK, because to set up the fund on-shore would lead to tax inefficiencies since the fund would be treated as "trading" rather than "investing" for UK tax purposes. Instead, hedge fund structures will invariably include a company or limited partnership established in an off-shore jurisdiction.

2.2 Please describe the limited liability of investors.

In respect of funds structured as limited partnerships, under statute the liability of a limited partner for the debts and obligations of the partnership is limited to the amount of capital it contributes to the partnership, subject always to the caveat that the investor does not become involved in the management of the structure.

This does not relieve the investor of its contractual obligation to advance money and therefore Alternative Investment Funds operating "just-in-time" drawdown structures will be able to draw the full amount the investor has committed to advance to the fund, notwithstanding the statutory limitation on liability. The UK limited partnership will generally be structured so that the commitment of investors comprises a nominal amount of capital contribution, with the balance being advanced by way of a loan. This structure should avoid amounts distributed to investors being subject to return in the event of the insolvency of the limited partnership.

The other fund vehicles available will provide for the limited liability of investors, such that they will not be required to contribute more than the amount which they have committed to invest in the fund.

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2.3 What are the principal legal structures used for managers and advisers of Alternative Investment Funds?

There are no formal requirements as to the legal structure used for managers and advisers of Alternative Investment Funds. However, the two most common structures seen in the market are the private limited company and the limited liability partnership (LLP). LLPs are increasingly being seen as the preferred structure as they offer the tax transparency of a traditional partnership whilst offering limited liability to the members of the LLP. Although an LLP is a body corporate, it is an inherently more flexible vehicle than a limited company and therefore can be adapted to suit the particular circumstances of the fund manager's business and preferred governance structure.

Historically, each member of an LLP has been treated as being self-employed for tax purposes. This has meant that LLPs have not needed to pay employer's national insurance contributions (NICs) on the remuneration of members and it has also kept members of an LLP outside of the UK employment related securities (ERS) legislation.

Since the introduction of the "salaried member" rules in 2014 however, the position is no longer quite so straightforward. Under the new rules, a member of an LLP will be treated as an employee if they: (a) perform services for the LLP in return for a "disguised salary" (broadly, remuneration which is not dependent on the firm's profitability); (b) do not have "significant influence" over the LLP's affairs; and (c) make a capital contribution to the LLP which is less than 25% of their annual "disguised salary". If a member meets all three conditions, they will be deemed to be an employee and the LLP will need to pay employer's NICs on their remuneration and the member will be brought within the scope of the ERS legislation.

Although it is still too early to say what the full effect of the salaried member rules will be, they may encourage managers to reconsider the structure of their business and the advantages of using an LLP as their preferred vehicle.

2.4 Are there any limits on the manager's ability to restrict redemptions in open-ended funds or transfers in open-ended or closed-ended funds?

Generally there are no statutory or regulatory limitations on the ability of managers of private funds to restrict redemptions or transfers in either open-ended or closed-ended funds, although contractual restrictions may be imposed.

2.5 Are there any legislative restrictions on transfers of investors' interests in Alternative Investment Funds?

There are no legislative restrictions on the transfer of investors' interests. However, in the case of UK limited partnerships, certain filing requirements will need to be met, and details of the transfer advertised, before it is deemed to be effective.

3 Marketing

3.1 What legislation governs the production and offering of marketing materials?

Following the implementation of AIFMD, marketing has become one of the more difficult issues a manager of Alternative Investment Funds has to grapple with, as managers need to consider both domestic and pan-European legislation.

Under FSMA, the communication of financial promotions is restricted. Generally, financial promotions are permitted if they are made or approved by an entity authorised by the FCA. However, in the context of unregulated collective investment schemes (which will catch most private funds), there are further restrictions which limit even the scope for authorised persons to make financial promotions.

Units in unregulated collective investment schemes will, to the extent made by an entity which is not authorised by the FCA, need to be marketed in accordance with the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (FPO) or, to the extent made by an entity which is authorised by the FCA, need to be marketed in accordance with either the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) Order 2001 or the provisions of the conduct of business rules contained as a component part of the FCA Rules.

In addition to the domestic regime, additional marketing restrictions are imposed by AIFMD and the Delegated Regulation. UK AIFMs wishing to market a UK AIF or EEA AIF to retail or professional investors in the UK are required to apply to the FCA to do so.

3.2 What are the key content requirements for marketing materials, whether due to legal requirements or customary practice?

Under domestic legislation, there are limited content requirements applicable to marketing materials, although there is an overarching obligation to ensure that marketing materials are "clear, fair and not misleading". AIFMD has changed the rules somewhat, by including prescribed pre-investment disclosures which must be made to prospective investors. Whilst many of these disclosures (set out in Article 23 of AIFMD) are largely consistent with information that has historically been included in marketing materials for private funds, there are specific components of the disclosure regime which will either be new or enhance the level of detail previously provided.

The requirements of the EU Prospectus Directive which catch "offers to the public" will generally not apply to the marketing of Alternative Investment Funds on the basis that the requirements can be avoided if, broadly, the minimum subscription per investor is €100,000 or if the fund is offered to fewer than 150 investors per EEA state. The EU Prospectus Directive will also not catch open-ended vehicles, so most hedge funds, for example, would not be caught in any event.

3.3 Do the marketing or legal documents need to be registered with or approved by the local regulator?

Outside of AIFMD, there is no requirement to register marketing or legal documentation with the FCA. However, an AIFM must submit certain marketing information to the FCA (through the FCA's Cross-Border Marketing Passport Form and UK Marketing Form) 20 working days prior to marketing and must obtain pre-clearance for any material planned changes to the information provided (the AIFM must give one calendar month's notice of the changes). Material unplanned changes must be notified to the FCA immediately.

3.4 What restrictions are there on marketing Alternative Investment Funds?

For the purposes of AIFMD, marketing is a direct or indirect offering or placement at the initiative or on behalf of the AIFM to or with investors domiciled within the EU. This is a narrower concept than that of a financial promotion under domestic regulation, which is an offer or inducement to engage in investment activity. The FCA has provided guidance on when it considers an AIFM to be

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marketing in the UK. There are two situations when an AIFM may not be regarded as marketing an AIF: (i) pre-marketing; and (ii) reverse solicitation. The pre-marketing will be permissible where it is based on draft documentation and the offer document, or other information, is not sufficiently detailed to enable the recipient to make an investment decision or submit a subscription request, for example, a pathfinder document should not amount to marketing. In addition, "marketing" does not include general public statements, the issuance of capital calls or secondary trading.

In respect of reverse solicitation, the FCA guidance states that a confirmation from the investor that the approach was made at its own initiative should be sufficient to rely on this approach. The guidance, however, also states that it must be received prior to making the offer or placement.

From 22 July 2014, an authorised AIFM is able to market to professional investors only on the basis of the AIFMD passport.

Marketing by small AIFMs (i.e. sub-threshold firms) will be subject to a lighter touch regime; broadly, UK small AIFMs will be able to market all sub-threshold AIFs in accordance with the domestic financial promotion regime.

Off-shore managers of off-shore Alternative Investment Funds may market into the UK on the basis of the financial promotion regime. However, they will be required to comply with the transparency and (if relevant) private equity disclosure requirements imposed under AIFMD.

3.5 Can Alternative Investment Funds be marketed to retail investors?

AIFMD effectively leaves the question of marketing to retail investors to the discretion of Member States. The UK has retained provisions which allow marketing to retail investors. If an AIFM is permitted to market to professional investors, it can also market to certain types of retail investors (effectively qualifying high-net-worth or sophisticated investors) provided it does so in accordance with the UK financial promotion regime. The financial promotion regime has changed recently with the effect that, where the promotion is being made in accordance with the conduct of business rules contained in the FCA Rules, in addition to the investors having to fall within the terms of the exemptions themselves, the issuer of the financial promotion must undertake a suitability assessment to ensure that the investment is appropriate for the prospective investor. This suitability assessment needs to be undertaken prior to the point at which the financial promotion is issued.

3.6 What qualification requirements must be carried out in relation to prospective investors?

There are no "across the board" qualification requirements which apply in relation to prospective investors, although certain of the bases on which marketing is made under the financial promotion regime (or, where applicable, AIFMD) will require an analysis of the circumstances of the prospective investor.

AIFMD introduces a passport which facilitates marketing to professional investors on a pan-European basis. For the purposes of AIFMD, a professional investor is one who could be so regarded under MiFID. Although most institutional investors are likely to be professional investors *per se*, it may prove difficult to opt people into professional status (it is a higher bar than most UK managers are used to). Investors who are not professional investors will be retail investors.

3.7 Are there additional restrictions on marketing to public bodies such as government pension funds?

There are no additional restrictions to those which otherwise apply under the financial promotion regime.

3.8 Are there any restrictions on the use of intermediaries to assist in the fundraising process?

There are no restrictions on the use of intermediaries, although if the intermediary is itself carrying on regulated activities for the purposes of the UK regulatory regime, it will need to be authorised by the FCA.

3.9 Are there any restrictions on the participation by financial institutions in Alternative Investment Funds (whether as sponsors or investors) arising from the 2008 financial crisis?

Under the current legislative and regulatory regime, there are no firm restrictions on financial institutions participating in Alternative Investment Funds – however, there may be regulatory capital costs to financial institutions in respect of their investment positions.

Under AIFMD, AIFMs are limited in terms of the additional activities they are able to undertake and therefore certain financial institutions may need to restructure their operations to ensure that they are compliant with the provisions of AIFMD.

4 Investments

4.1 Are there any restrictions on the types of activities that can be performed by Alternative Investment Funds?

Generally speaking, there are no restrictions, although the fund manager will need to ensure that the activities it is carrying out in respect of the Alternative Investment Fund are consistent with the scope of permission it has to carry out regulated activities (and with the contractual investment policy of the Alternative Investment Fund).

However, AIFMD does impose certain restrictions relating to asset stripping, whereby there are limitations on some distributions or deemed distributions from a non-listed company in relation to which the AIFM has acquired control within 24 months following the acquisition of control.

In addition, although not restrictions, there are certain deal disclosure requirements under AIFMD. In this regard, an AIFM must notify the FCA when an AIF's voting interest in an unlisted company passes through certain thresholds. There are additional disclosure obligations when an AIF acquires "control" of an EU company (the test as to control varies according to whether the investee company is listed or unlisted). Investments by an AIF may also trigger a requirement to make certain information available to the FCA, the investee company and remaining shareholders (including, for unlisted companies, intentions as to the company's future business and the likely repercussions on employees). In the context of unlisted companies, relevant information must be passed to employee representatives (subject to limited exceptions).

4.2 Are there any limitations on the types of investments that can be included in an Alternative Investment Fund's portfolio whether for diversification reasons or otherwise?

There are no such limitations.

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4.3 Are there any restrictions on borrowing by the Alternative Investment Fund?

In the context of private funds, there are currently no statutory or regulatory limitations on borrowing, although contractual restrictions are common. In the context of AIFs covered by AIFMD, certain of the pre-investment disclosures relate to the use of leverage. In particular, an AIFM must disclose: the circumstances in which the AIF may use leverage; the types and sources of leverage permitted and the associated risks; any restrictions on the use of leverage and any collateral and asset re-use arrangements; and the maximum level of leverage the AIFM is entitled to employ on behalf of the AIF.

5 Disclosure of Information

5.1 What public disclosure must the Alternative Investment Fund make?

Alternative Investment Funds structured as limited partnerships will need to comply with the registration requirements under the 1907 Limited Partnerships Act. There may be a requirement on the general partner of a UK limited partnership to file the partnership's accounts on the basis of the Partnership Accounts Regulations.

5.2 What are the reporting requirements in relation to Alternative Investment Funds?

AIFMD and the Delegated Regulation require AIFMs to comply with a range of detailed regulatory reporting obligations. Reporting obligations also apply to non-EEA AIFMs seeking to market their funds under national private placement regimes.

Broadly, AIFMs will be required to make periodic reports to the FCA in accordance with AIFMD using a set of prescribed forms set out in the Delegated Regulation and in line with ESMA's final guidelines. The EMSA guidelines, published in November 2013, were accompanied by a number of electronic reporting templates in the XML format, together with guidance on the preparation of systems capable of generating XBRL reports. In addition to the annual reports in respect of each managed AIF, AIFM will need to provide periodic reports relating to the AIFM itself and in respect of each AIF that it manages (including information in relation to investment strategies, main instruments traded, principal exposures, risk profiles and (where relevant) leverage).

The FCA has published various guidance papers on periodic reporting, setting out what information is required and how, and when, it should be reported. The FCA has an online reporting system, GABRIEL, which assists UK AIFMs with meeting their requirements.

5.3 Is the use of side letters restricted?

There are no firm restrictions on the use of side letters. However, AIFMD requires disclosures as to how AIFMD ensures the fair treatment of investors and, if side letters are used to provide preferential treatment to investors, a description of the preferential treatment and the type of investors to whom the treatment is made available will need to be disclosed. If the AIFM operates a general most-favoured nations (MFN) mechanism, this is unlikely to be an issue; however, if no or a limited MFN process is in place, AIFMD will need to consider its use of side letters in the light of the disclosure requirements under AIFMD.

6 Taxation

6.1 What is the tax treatment of the principal forms of Alternative Investment Funds?

UK limited partnerships are not taxable entities for UK direct tax purposes and are instead fiscally transparent. This fiscal transparency means each limited partner is treated for UK tax purposes as owning his proportionate share of the assets of the partnership and is subject to tax on the income and gains allocated to it under the limited partnership agreement (whether or not they are distributed).

6.2 What is the tax treatment of the principal forms of investment manager/adviser?

The tax treatment of the manager or adviser will depend on whether it is constituted as a company or an LLP. If a company, it will be subject to corporation tax on the fees paid by the fund (at 20% from 2015). The management team takes their remuneration in the form of salary and the excess profit can be extracted as dividend income. If the manager is an LLP, it is fiscally transparent so the fees paid to the manager are automatically taxed in the hands of its members. As noted above, the new salaried member rules will be used to ascertain whether a member should be taxed as a self-employed person or an employee. All of the LLP's members, regardless of where they are resident, must pay UK tax on their share of the LLP's profits.

In terms of funds structured as limited partnerships, where the general partner appoints a manager to manage the partnership, the fee payable to the manager will in principle attract value-added tax (VAT). This is most often managed by ensuring that the manager and the general partner are in the same VAT group.

The UK is not typically used as a domicile for hedge funds, but it is a popular location for investment managers of hedge funds, and this is in part because of the Investment Manager Exemption (IME). Provided certain conditions are met, the IME ensures that a UK investment manager managing a non-UK hedge fund will not constitute a permanent establishment of the hedge fund in the UK. The IME enables a non-UK resident fund that is trading for UK tax purposes to appoint a UK-based investment manager without the risk of that part of the fund's profit that is attributable to the activity of the investment manager in the UK becoming subject UK tax.

6.3 Are there any establishment or transfer taxes levied in connection with an investor's participation in an Alternative Investment Fund or the transfer of the investor's interest?

There are no establishment taxes levied in connection with an investor's participation in an Alternative Investment Fund. Stamp duties may be payable on the transfer of limited partnership interests if the partnership property includes stock or marketable securities, although there are a number of methods of mitigating the effect of such taxes. Stamp duty land tax may be payable where the partnership property includes land.

6.4 What is the tax treatment of (a) resident and (b) non-resident investors in Alternative Investment Funds?

The use of tax-transparent limited partnerships as the primary vehicle for Alternative Investment Funds means that income and gains received by the fund are treated as if they had been received

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by the fund's investors directly. The taxation of the returns depends on whether the fund is treated as trading or investing.

The question of whether or not a fund is carrying on a trade in the UK is largely a question of fact. In practice, this is determined by applying various criteria derived from case law – often referred to as "badges of trade" – to a fund's transactions. For example, churning investments and investing and divesting opportunistically would be likely to be indicative of a trading activity, whereas holding long for income and capital would be more likely to be considered as an investment activity.

Private equity funds (the main users of the limited partnership structure) usually intend to buy and hold securities for mid to longer term in order to achieve long-term capital appreciation. Consequently they are more likely to be considered as investing rather than trading.

If the limited partnership is treated as investing then, as a result of its tax transparency, profit distributions from the limited partnership retain their character as capital gains or investment income and are taxed accordingly. The tax payable by a particular investor will depend upon its own tax profile. For example, if the fund receives dividend income, this would be taxed in the hands of a UK resident individual but a UK pension fund investor should not be subject to UK tax on such investment income. Most non-resident investors will only be subject to UK tax on UK source investment income to the extent that it is subject to withholding tax. Withholding taxes are potentially relevant to both UK interest and UK rental income (but not dividends), but there are reliefs from withholding. Generally, non-resident investors should not be subject to UK tax on capital gains unless they hold their interest for the purposes of a UK trade.

If the limited partnership is treated as trading for UK tax purposes, UK resident investors and non-UK resident limited partners will be subject to income tax (or corporation tax on trading income) on their share of trading profits and gains. This will be of particular concern for UK pension fund investors (who are only exempt from UK tax on investment income and gains). Non-UK resident investors will be caught because the partnership will constitute a taxable presence in the UK through which the non-resident is carrying on a trade.

Investors should be aware of the annual tax on enveloped dwellings (ATED) and the extension of the capital gains tax legislation to ATED-related gains. The ATED rules and the capital gains tax rules will need to be considered carefully when a fund invests in UK residential property.

Where a UK limited partnership receives income from non-UK jurisdictions that levy withholding tax, or receives capital proceeds from the sale of an asset situated in a jurisdiction which might tax that gain, then limited partners may seek to rely on the terms of a double tax treaty in order to obtain relief. Whether such relief is available will depend, in part, upon whether that non-UK jurisdiction treats a UK limited partnership as fiscally transparent.

6.5 Is it necessary or advisable to obtain a tax ruling from the tax or regulatory authorities prior to establishing an Alternative Investment Fund?

Generally speaking, it is not necessary to obtain tax rulings prior to establishing an Alternative Investment Fund.

6.6 What steps are being taken to implement the US Foreign Account and Tax Compliance Act 2010 (FATCA) and other similar information reporting regimes?

The UK has entered into an Intergovernmental Agreement (IGA) with the US. Alternative Investment Funds established in the UK will have to carry out due diligence to identify US investors and non-FATCA compliant investors and will then have to report information about such investors to HMRC. Compliant UK funds will not be subject to, nor will they have to operate, FATCA withholding taxes.

The UK has also entered into IGAs with the Channel Islands and Overseas Territories. The IGAs between the UK and the Channel Islands and Gibraltar are 'reciprocal', which means that UK funds will have to carry out similar due diligence and reporting exercises in relation to their investors in those jurisdictions.

In addition, the proposed OECD Common Reporting Standard for Automatic Exchange of Financial Account Information (CRS) and the EU Directive on administrative cooperation in the field of taxation (DAC) are due to be implemented into UK law during 2015. Accordingly, UK funds will need to monitor the progress of these rules in order to ensure that they are compliant.

6.7 Are there any other material tax issues?

The tax position of an investor in a UK Alternative Investment Fund will inevitably depend upon its own tax profile – accordingly investors should always seek independent advice on the tax implications of participating in the fund and managers should advise investors of this fact.

In addition to tracking the CRS and the DAC, UK Alternative Investment Funds will also want to watch the progress of the OECD's BEPS (base erosion profit shifting) project and its potential impact on their investment structures.

7 Reforms

7.1 What reforms (if any) are proposed?

Following the significant regulatory changes introduced by AIFMD, it would be comforting to think that there would now be a pause for breath in terms of further changes. However, the direction of travel in terms of the regulatory requirements imposed on firms operating in the Alternative Investment Funds space is clear, and there is already some discussion within the industry over AIFMD 2.

MiFID is now being comprehensively revised to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection by way of a recast directive and regulation, commonly referred to as "MiFID II". How the FCA chooses to transpose the directive element of MiFID II could lead to developments in this area for the UK Alternative Investment Funds industry.

Another piece of legislation bringing reform and which could have an impact on Alternative Investment Funds is the Small Business, Enterprise and Employment Bill. Potential areas of impact include (i) a prohibition on the use of corporate directors (although, currently, there is a carve-out for LLP entities), (ii) extending the UK Companies Act 2006 duties on directors to shadow directors, and (iii) an obligation on companies to disclose the identity of beneficial owners in a newly publicly available register of persons with significant control. Private equity managers may need to identify any person who has significant control over their portfolio managers.

In short, practitioners within the industry will need to ensure that they keep abreast of developments and consider whether they should be engaging with the industry in lobbying to try and ensure that any proposed regulatory excesses can be curbed.

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