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Investment Funds

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Travers Smith LLP investment funds group comprises four partners and 15 other dedicated fee earners, based in London. The group focuses on funds, investors and intermediaries in the private equity, infrastructure, debt, real estate and listed equities sectors. It has constantly been at the forefront of developing market practice and thought on relevant changes for the investment funds industry, including the European Alternative Investment Funds Managers Directive and, more recently, the potential impact of Brexit. The funds tax group advises on the structuring of investment funds to maximise their tax efficiency for investors

and managers. The investment funds group sits alongside the firm's market-leading private equity M&A practice, one of the largest transactional teams of private equity lawyers in the City. The funds finance practice combines expertise from the firm's fund formation and finance practices to advise lenders that provide subscription line and other facilities to real estate funds. Travers Smith also advises real estate funds on the borrower side. The investment funds group is best known for private funds and closed-end listed funds.

Authors



Sam Kay heads up the investment funds group and specialises in fund formation work for a wide range of private funds. He has 20 years' experience of working on investment funds projects and he has been a partner at Travers Smith since 2008. Sam

also works on secondaries transactions, carried interest arrangements and co-investment schemes, advising institutional investors on their participation in funds and internal restructurings, succession planning and management spin-outs. His clients include social enterprise funds, venture and growth capital funds, mid-market funds and larger asset management platforms. Sam regularly advises on cross-border fund structuring issues. He trained at Travers Smith and qualified into the investment funds team before becoming head of the investment funds group in 2009.



Elena Rowlands specialises in the taxation of asset managers and investment funds, and has particular expertise in the structuring and formation of private and listed alternative investment funds, with a focus on private equity, venture, debt,

infrastructure and real estate funds. She also specialises in advising fund managers on their internal house tax issues – including restructurings, incentive arrangements and tax authority disputes – and advising institutional investors on the tax risks associated with investing in particular fund structures. A high proportion of her work has an international element. Elena is a member of the Alternative Investment Management Association's working groups on the Organisation for Economic Co-operation and Development's base erosion and profit-shifting strategies and partnerships, and a member of the Income Tax Sub-committee of The Law Society.

1. Fund Formation

1.1 Formation of 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. 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. Within the UK market, alternative investment funds can be, broadly, divided between closed-ended funds that focus on illiquid asset strategies (eg, private equity, real estate and infrastructure funds) and open-ended funds that focus on liquid asset strategies (eg, hedge funds). The common structures will be different between these two categorisations.

Private closed-ended funds, often structured as English limited partnerships, are commonly used for funds that focus on illiquid asset strategies (eg, private equity, venture capital, real estate and infrastructure funds).

Listed closed-ended funds available for sale to the general public are also common and used for both liquid and illiquid asset strategies. The vehicle most often used is an investment trust (ITC). For funds which intend to invest in UK real estate, authorisation as a real estate investment trust (REIT) may be possible provided the relevant conditions are met.

Open-ended vehicles can be 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. 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. However, a NURS does not benefit from the UCITS marketing passport.

The UK provides for a large number of open-ended vehicles which fall within these two categories. These include author-

ised unit trusts (AUTs), open-ended investment companies (OEICs) and authorised contractual schemes (ACSs). The regulatory regime is substantially the same regardless of the legal form of the fund. Different authorisations apply, depending upon the investments to be made by the OEIC. For example, OEICs which invest in real estate may, provided the relevant conditions are met, be structured as property authorised investment funds (PAIFs), and OEICs which invest in unauthorised funds need authorisations as “FAIFs”, funds of alternative investment funds.

1.2 Raising Capital from Investors

The UK successfully raises capital from investors from all over the world. The strength of the UK market, and the expertise developed by UK advisers and managers, has, in turn, triggered significant outward expansion, with many UK fund managers now implementing their investment strategies on a pan-European or global basis.

1.3 Common Process for Setting Up Investment Funds

Private Closed-Ended Funds

The statutory framework in the UK requires that an English limited partnership is 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; this is a freely negotiated contract, with very few provisions prescribed by law, and not available publicly. All parties will heavily negotiate the agreement prior to its execution. Other key fund documentation often used include 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 Closed-Ended Funds

An ITC is typically a UK public limited company which has been approved by Her Majesty's Revenue & Customs (HMRC) as an ITC for the purposes of the relevant tax legislation. Investment trusts are subject to special tax rules (discussed below). Similarly, a REIT is typically a UK public limited company which 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).

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 are met in order to gain the tax advantages enjoyed by these vehicles. Tax lawyers should be engaged early in the process to provide advice on the steps necessary for a company to meet these requirements. Offers in respect of ITCs and REITs are subject to the obligation to publish a prospectus under the domestic legislation incorporating the EU Prospectus Directive. The other key document produced will be the investment management agreement for the fund to appoint the manager.

Since January 2018, under the Packaged Retail and Insurance Based Products (PRIIPs) Regulation a short, standardised disclosure document containing key information about the product being offered, a key information document (KID), must also be produced and published for investment products marketed to retail investors in the EEA.

Open-Ended Funds

By comparison, open-ended funds are relatively easier and cheaper to set up, notwithstanding the fact that the fund itself requires prior regulatory authorisation. Open-ended funds have their own constitutional documentation, depending upon which type of vehicle is being set up:

- 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. For both UCITS and NURS funds, however structured, there are very detailed operational requirements. Day-to-day operations are then detailed in the fund's prospectus.

1.4 Regulation of Fund Structures

Private and Listed Closed-Ended Funds

Closed-ended funds are not required to have a UK manager. While many do, it is also equally common to see UK funds managed by EEA and non-EEA management entities.

Open-Ended Funds

The manager of an open-ended fund must be a UK firm authorised by the Financial Conduct Authority (FCA). In the case of UCITS funds, it is also possible for the manager to be an EEA UCITS management company. In the case of a NURS, it is possible for the manager to be an EEA AIFM.

1.5 Limited Liability

Private Closed-Ended 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 Closed-Ended Funds

Under UK companies' legislation, the liability of the shareholders for company debts is limited to the capital originally invested in the fund.

Open-Ended Funds

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 and under UK law the assets and liabilities of each sub-fund are ring-fenced.

1.6 Common Tax Regimes

As can be seen from the previous discussions, there are a variety of different UK fund structures available. As a general point, an important concept in the way that the UK deals with UK investment funds from a tax perspective is that investors should, as far as possible, be put in the same position as if they had invested directly in the underlying assets. This is typically achieved either through tax transparency or by the availability of special tax regimes. A high-level overview of some of the key direct tax features of some of the most common types of fund structure is set out later in this Chapter.

1.7 Investment Sponsors

The UK is a popular and commonly used jurisdiction for sponsors from all over the world.

1.8 Disclosure Requirements

Private Closed-Ended 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-authorized person. Under the Alternative Investment Fund Managers Directive (AIFMD), 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 Closed-Ended Funds

In addition to the AIFMD 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 and REITs must also publish annual and half-yearly reports and accounts. The annual report and accounts must be prepared in accordance with applicable accounting standards and must give a true and fair view of the assets, liabilities, financial position and profit and loss of the company. Half-yearly 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.

Open-Ended Funds

Investors in open-ended funds must have access to an up-to-date prospectus at all times. A key information document must also be prepared and be made available to potential investors under the UCITS Directive (the UCITS KID). The UCITS KID requirements differ from 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. Further, it must be provided to both potential retail and professional investors (whereas the PRIIPs KID is required only to be made available to retail investors).

1.9 Legal Forms

Private Closed-Ended Funds

The typical structure of a UK private equity or venture capital fund is most commonly an English limited partnership, 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, who is responsible for the management of the limited partnership, and one or more limited partners.

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, for example 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. 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 are 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. 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 been used for certain real estate fund structures.

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 Closed-Ended Funds

ITCs and REITs 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. As public limited companies, ITCs and REITs will have a board of directors who are responsible for managing its affairs. The board of directors will 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 FCA.

Open-Ended Funds

For an open-ended structure, an OEIC can be used. This is a collective investment scheme structured as a corporate vehicle. Different authorisations apply, depending upon the investments to be made by the OEIC. For example, OEICs which invest in real estate may, provided the relevant conditions are met, be structured as PAIFs. 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 is managed by the manager. The investors have beneficial ownership of the property of the fund.

In 2013, two new types of tax transparent fund, 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 as it is more straightforward to administer. ACSs are only suitable for use by institutional investors. Investment is restricted to either investments of a minimum of GBP1 million or to professional institutional investors. Retail investors could, however, access ACSs through a feeder fund.

Hedge Funds, EuVECAs and ELTIFs

A classic hedge fund structure in the UK would not include the actual hedge fund being domiciled in the UK. This is often because, to set up the fund onshore would lead to tax inefficiencies because the fund would be treated as "trading" rather than "investing" for UK tax purposes. Instead, hedge fund structures will invariably include an offshore company or offshore 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. For this reason, hedge funds are therefore not discussed in detail in this chapter.

The EU has also enacted the European Venture Capital Funds (EuVECAs) Regulation for certain sub-threshold, venture capital-focused managers, and the European long-term investment funds (ELTIFs) Regulation for funds investing in long-term investments, both of which are directly applicable in the UK. However, to date, there has been little uptake of EuVECAs or ELTIFs in the UK. Again, for this reason, neither EuVECAs nor ELTIFs are therefore discussed in detail in this chapter.

1.10 Regulatory Status

Private and Listed Closed-Ended Funds

The UK does not directly regulate closed-ended funds themselves. Instead, regulation falls on the manager. Each closed-ended fund vehicle is likely to be an alternative investment fund (AIF). An AIF is defined by the AIFMD as a collective investment undertaking that raises capital from a number of investors, with a view to investing that capital in accordance with a defined investment policy for the benefit of those investors. (ESMA expands on these concepts in its Guidelines on Key Concepts of the AIFMD). Accordingly, the fund manager is likely to require authorisation and permission from the FCA to carry out AIF management in respect of that vehicle.

Some vehicles used in private closed-ended structures may not fall within the definition of an AIF. Examples include staff carried interest vehicles structured as limited partnerships (which are unlikely to be AIFs because of the AIFMD employee participation schemes exclusion) and certain deal-specific co-investment vehicles. These vehicles, if not AIFs, are nonetheless likely to be collective investment schemes (CIS) under FSMA. A CIS is similar to the EU concept of a collective investment undertaking, but is broader. Establishing, operating or winding-up a CIS is a separate regulated activity, requiring authorisation by the FCA.

Historically, ITCs were not regulated entities. Following the adoption of the AIFMD, some investment trust companies may regard themselves as AIF managers (because they are internally managed AIFs) and become authorised under the AIFMD. However, most ITCs have an external manager that is acting as the AIF manager and will not, therefore, be regulated directly.

Open-Ended Funds

Both UCITS and NURS funds are regulated funds that require prior authorisation from the FCA. The FCA has a statutory two-month period to review and consider an application for a UCITS and a six month period for a NURS applications. Once authorised, the funds must comply with detailed FCA rules as these vehicles are heavily regulated (in comparison to closed-ended vehicles). In particular, these funds are subject to stringent investment and borrowing restrictions.

1.11 Legal, Regulatory or Tax Legislative Changes

Brexit will clearly have an impact on fund managers and fund vehicles operating and/or marketing, in the UK. As, at the time of writing, it is not known whether the UK will exit the EU on the basis of a deal and related transition period or no deal, the exact implications are difficult to ascertain.

Were a transition period to be agreed and put in place, the UK would continue to implement new EU investment funds legislation which takes effect during that time. This means that the UK may potentially be required to implement some very significant measures which are currently being negotiated, including resultant legislation from the upcoming reviews of the AIFMD and the PRIIPs regime, in addition to the new legislation relating to the cross-border distribution of investment funds (frequently referred to as the “Omnibus” package).

Those most affected by a no-deal Brexit would be UK full-scope AIFMs relying upon a managing or marketing passport. As the UK will immediately become a third country in the event of a no-deal Brexit, these AIFMs will no longer be able to rely upon passporting regimes and will instead only be able to market under national private placement regimes (NPPR). Full-scope AIFMs established in other EEA member states would no longer be able to manage a UK AIF or to market to UK investors under the AIFM passport in the event of a no-deal Brexit. To address this, the FCA has proposed a temporary permissions regime. Sub-threshold AIFMs will not be affected to the same extent as full-scope AIFMs; having never had access to the AIFM directive passport, they will continue to market under the NPPR. Similarly, non-EEA AIFMs would also continue to market under NPPR.

Post-Brexit, access to equity capital markets for listed funds will be affected. As the UK will no longer be a Member State,

UK companies will not be able to raise capital in the EEA using a prospectus approved by the UKLA and “passport” into Europe. However, it is likely that the UK and EU rules will remain largely aligned, and so it is unlikely that different documentation will be needed, at least in the short term. However, where a prospectus is required, this will need to be approved in an EEA state, as well as in the UK.

Post-Brexit, it will become possible for the UK to deviate from EU-mandated tax legislation. However, there has been no indication that the UK will amend its tax legislation as a result of Brexit in ways which are likely to impact significantly on funds in particular.

As to other upcoming changes, the legislation which governs UK limited partnerships (the principal fund vehicles used for UK domiciled private funds), the Limited Partnerships Act 1907, is currently the subject of reform proposals. The proposals have been put forward in response to concerns that Scottish limited partnerships are being used in illegal activities. The UK government has taken the opportunity to consider how effective controls can be built into the entire lifecycle of limited partnerships. The proposals relate to:

- stronger registration requirements;
- a requirement that the limited partnership will need to demonstrate that it maintains an ongoing connection to the UK;
- a requirement for the filing of an annual confirmation statement, confirming that all information on the Register at Companies House is correct; and
- giving the Registrar powers to strike-off limited partnerships.

In relation to open-ended funds, the FCA has put forward proposals aimed at ensuring adequate liquidity in open-ended funds investing in illiquid underlying assets. Broadly speaking, a fund will be within scope of the proposed new requirements if it is a NURS which invests, or intends to invest, at least 50% by value of the fund’s property in inherently illiquid assets.

From April 2019, non-residents will be subject to UK tax on the disposal of interests in UK land or UK-land-rich entities. The rules contain specific provisions which explain how this new tax charge will apply in the case of investment funds, but these provisions are highly complex and there remains a degree of uncertainty as to how they will be applied in practice. A summary of these new rules is outside the scope of this chapter, but it should be noted that non-resident investors in UK investment funds (particularly real estate funds) may be subject to this new UK tax charge.

2. Fund Investment

2.1 Types of Investors

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. Closed-ended listed funds can be marketed broadly and attract both institutional and individual investors. Similarly, where the fund is a UCITS or NURS there are no restrictions on the types of investor to whom the fund can be marketed.

2.2 Legal, Regulatory and Investment Structures

The legal, regulatory and investment structures chosen by an investor will depend upon a number of factors, such as the tax treatment of the proposed investment, and any income derived therefrom, for the investor and the risk appetite of this investor.

2.3 Legal, Regulatory or Tax Themes/Issues

The types of UK domiciled funds available to investors vary greatly, both in legal structure and the level of regulatory oversight. The range of options available allows investor choice and flexibility and is seen as one of the advantages of the UK industry.

As mentioned above, an important concept in the way that the UK deals with UK investment funds from a tax perspective is that investors should, as far as possible, be put in the same position as if they had invested directly in the underlying assets.

2.4 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 which can invest in a fund.

2.5 Marketing Restrictions

The question of who may invest in funds essentially turns on the rules which determine to whom these funds may be marketed. The two main investor categories in relation to the distribution of funds in the UK are “professional investors” and “retail investors”.

For instance, in keeping with the focus of AIFMD generally, the AIFMD marketing provisions are predicated on the marketing of AIFs to “professional investors” within the EEA. Individual member states are granted discretion as to whether to allow AIFMs to market units or shares in AIFs to “retail investors” in their territory, ie investors who are not “professional investors”. The UK has exercised its discretion to allow such marketing to certain categories of “retail investors” (eg, high net worth investors, sophisticated investors and employees). Open-ended funds can only be distributed to retail investors.

Certain additional requirements are imposed under the terms of the AIFMD (in respect of closed-ended funds) and the UCITS Directive (in the case of open-ended funds). Marketing can only be undertaken following the manager giving the FCA the required notice of the proposed marketing and filing the relevant documents with the FCA. Certain pre-investment disclosures must also be made to investors.

3. Regulatory Environment

3.1 Regulatory Regime

Closed-Ended Funds

As stated above, a closed ended fund in the UK will almost certainly be an AIF for the purposes of the AIFMD. As such, the AIF’s manager will be an alternative investment fund manager (AIFM) for the purposes of the AIFMD 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 exclusion, commits an offence. In addition, if he or she has 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 his or her money back, and to compensation for any loss.

An investment trust could be self-managed or managed by an external manager. The board of an externally managed ITC will generally consist of non-executive directors, the majority of whom must be independent of the investment manager. In many cases investment trusts will now have no manager representative on the board, due to its unpopularity with investors.

Open-Ended Funds

The manager of open-ended authorised funds must be authorised by the FCA, with permission to either “manage a UCITS” or “manage an authorised AIF”. A management company authorised in another EEA state may also manage an open-ended fund in the UK.

Each open-ended fund must also have a depositary which, in the UK, is a regulated activity for which the depositary must hold the appropriate FCA permissions.

3.2 Territorial Reach of Regulators

It is possible for EEA-authorised AIFMs and UCITS managers to provide management services to a UK domiciled fund by exercising management passport rights available under the AIFMD or UCITS Directive, as the case may be. In order to exercise these rights, the manager must make a notification to its home state’s competent authority.

3.3 Regulatory Approval

Generally, a fund delegates investment management and it is usual to see delegation to either a FCA regulated investment management firm or to an investment manager domiciled outside of the UK. 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.

A non-EEA manager intending to market under the UK national private placement regime must give notice to the FCA under the AIFM Directive and conform to certain transparency obligations. In the future, non-EEA managers may be able to benefit from a marketing passport under the AIFM Directive if the European Commission has adopted a delegated act extending the availability of the passport to the jurisdiction in which they are based. The UK has adopted the Alternative Investment Fund Managers (Amendment) Regulations 2013 (SI 2013/1797), which will give effect to passporting rights of non-EEA managers in the UK, the provisions of which are contingent upon the European Commission first adopting the relevant delegated act.

In respect of closed-ended funds, there are three types of licence which are available to an AIFM which has its registered office in the UK:

- authorisation under FSMA as a full-scope UK AIFM;
- authorisation under FSMA as a small authorised UK AIFM; and
- registration as a small registered UK AIFM.

There are separate application forms in respect of each of these categories. The type of licence which is applicable to the manager will depend on the total amount of assets it has under management and the nature of the AIFs managed.

In respect of open-ended funds, marketing can only be undertaken once the required documents have been filed with the FCA.

3.4 Authorisation of Marketing Activities

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 either to make promotions 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.

In view of this, fund marketing activities in the UK are generally conducted only 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.

3.5 Investor-Protection Rules

As stated above, the two main investor categories in relation to the distribution of funds in the UK are “professional investors” and “retail investors”. A “professional investor” means an investor which 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. The list includes regulated financial entities, large undertakings, governments and public bodies and investors whose main activity is to invest in financial instruments.

Any investor which 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 AIFM must assess the expertise, experience and knowledge of the investor and whether this makes him or her capable of making his or her own investment decisions and understanding the risks involved (the “qualitative test”). The investor must further pass the “quantitative test”, meaning that the investor has satisfied two out of the three following requirements:

- having carried out transactions in 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 he or she may lose and he or she must state in writing that he or she is aware of the consequences of losing these protections and wishes to be treated as a “professional client”.

Open-ended funds can only be distributed to retail investors. Private closed-ended funds tend to be marketed only to non-retail investors. Listed closed-ended funds are available to both professional and retail investors.

3.6 Approach of the Regulator

The FCA is regarded as being co-operative and regularly publishes guidance on relevant regulatory matters.

4. Fund Finance

4.1 Access to 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, who 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 that at least ten business days' notice must 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. In addition to capital call facilities, other types of fund finance have been developed, including 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.

As regards open-ended funds, 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 purely on a 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. For NURS, the same 10% borrowing limit applies. However, there is no restriction on the length of time for which a NURS may borrow.

4.2 Borrowing Restrictions/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 buy-outs, 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 and

the amount of uncalled commitments) and any borrowing incurred must be on a "short-term" basis. Further, under AIFMD, any fund that incurs leverage (and for these purposes, short-term borrowing is excluded) 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.

4.3 Securing Finance

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 draw down 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 draw-down notices direct to the investors. For this to be possible, the lender must have the right to be assigned the right under the limited partnership agreement of the closed-ended private fund to issue these draw-down notices. 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 draw down 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.

4.4 Common Issues in Relation to Fund Finance

The most common issue in the UK is that investors will not want the fund to be leveraged. This is discussed in **4.2 Borrowing Restrictions/Requirements** above.

5. Tax Environment

5.1 Tax Framework

As mentioned above, there are a variety of different UK fund structures available. Various different tax regimes apply to them. These are complex, and a detailed summary of them is outside the scope of this chapter, but a high-level overview of some of the key direct tax features of common UK fund structures (both at fund and investor level) are set out below. Please note that the features described below are necessarily general and may not apply in certain cases, for example depending on the assets held by the fund or the circumstances of particular investors.

5.1.1 Overview of Tax Status of Common UK Fund Structures

Private closed-ended funds structured as English limited partnerships

As mentioned above, the typical structure of a UK private equity or venture capital fund is the English limited part-

nership. These are transparent for UK direct tax purposes. This means that each limited partner is subject to tax on the income and gains allocated to it under the limited partnership agreement (whether or not they are distributed).

English limited partnerships typically make payments to limited partners in the form of repayment of the loan element of the limited partners' partnership contributions and distribution of partnership profits. No UK withholdings taxes should apply to these payments.

Listed closed-ended funds

ITCs

Companies with ITC status are subject to UK corporation tax, but (provided certain conditions are met) are exempt from tax on capital gains and 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 an ITC to treat certain dividends to investors as interest distributions, enabling the ITC to claim a corporation tax deduction in respect of the interest distribution (provided certain conditions are met). One of the conditions for ITC status is that, broadly, it must not retain in respect of an accounting period more than 15% of its income for that period. As a UK company, an ITC can also potentially benefit from the general UK company exemptions from tax on dividends.

No withholding tax should apply to dividends paid to investors by ITCs, including, if the ITC enters into the elective interest streaming regime mentioned above, interest distributions.

REITs

A REIT is tax opaque but, provided certain conditions are met, benefits from an exemption from UK tax on profits and gains from its property rental business. Conditions with which a REIT must comply include that, broadly, at least 75% of its profits must come from its property rental business, at least 75% of the total value of its assets must be from assets relating to its property rental business, and it must distribute at least 90% of its property rental business profits.

Distributions by REITs in respect of the profits and gains of their property rental business are known as property income distributions (PIDs) and should be paid subject to withholding tax, unless an exemption applies (for example, if the REIT has a reasonable belief that the person beneficially entitled to the payment is subject to UK corporation tax).

Withholding tax should not apply to other distributions of profit paid by REITs.

Open-ended funds

OEICs (not including PAIFs) and AUTs

OEICs and AUTs are subject to UK corporation tax, but are exempt from tax on chargeable gains from disposal of assets. Furthermore, if these funds are marketed sufficiently widely (so that they satisfy the "genuine diversity of ownership" condition), then certain capital profits from investment transactions should be treated as exempt capital gains. 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 (these funds are often called "bond funds"). It meets this test, broadly, if the market value of investments which 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. If the qualifying investments test is not met, then all of the income available for distribution must be classed as dividends.

No withholding tax should apply to distributions paid to investors by OEICs or AUTs.

It is possible for OEICs and AUTs to elect to be treated as "tax elected funds". This would modify the tax treatment relating to OEICs and AUTs from that discussed in this Chapter. However, the uptake of this regime has in practice been low and so it is not discussed further here.

PAIFs

As mentioned above, OEICs which 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 PAIF status is that, broadly, a PAIF 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 of property income distributions, interest distributions and dividend distributions. Interest distributions may 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 subject to UK corporation tax). No withholding tax should apply to payments of interest distributions or dividend distributions.

ACSs

As mentioned above, 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, the more common ACS structure. CoACSs are transparent for the purposes of taxation of income and are not subject to taxation of chargeable gains. 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-resident investors).

Carried interest

Carried interest in relation to a private closed-ended fund structured as an English limited partnership is typically held via a separate limited partnership which becomes a limited partner in the main fund limited partnership. The UK tax treatment of carried interest is complicated, but the basic starting position is that once the hurdle has been reached and the carried interest kicks-in, carried interest participants pay tax depending on the nature of the profits allocated to them (eg, dividend, interest, gain or return of capital). However, there is a minimum special tax rate of 28% that applies to all carried interest returns regardless of their nature. In addition, various rules can apply which can result in carried interest being taxed as trading or employment income (at rates of up to 45% plus national insurance contributions) eg, under the “income based carried interest” rules, broadly, carried interest returns can be taxed wholly or partly as trading income if the fund’s average holding period of its underlying investments is less than 40 months.

5.1.2 Overview of tax position of investors in common UK fund structures

Private closed-ended funds structured as English limited partnerships

As mentioned above, a UK limited partnership is transparent for UK direct tax purposes. Each investor is treated as owning their share of the partnership’s assets, and is subject to tax on the income or gains allocated to it under the limited partnership agreement, whether or not distributed. The taxation of returns depends on the nature of the underlying partnership profit (and the investor’s own tax status).

Listed closed-ended funds

• ITCs

Investors in an ITC will be taxed on distributions (other than interest distributions) from it in the same way as for normal companies. Therefore, UK tax resident individuals will be subject to income tax (at rates of up to 38.1%) and corporation taxpayers can potentially benefit from the general UK company exemption from tax on dividends. Interest distribution 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 a receipt of taxable income.

REITs

For corporation tax and income tax payers, PIDs are generally treated as UK property income. UK resident individuals are therefore 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.

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 38.1%) and corporation taxpayers can potentially benefit from the general UK company exemption from tax on dividends.

Open-ended funds

OEICs (not including PAIFs) and AUTs

UK tax resident individuals will be taxed on dividend distributions in the same way as for normal companies. Therefore, UK tax resident individuals will be subject to income tax (at rates of up to 38.1%). The position for UK corporation taxpayers that receive dividend distributions is complex and is not considered further here.

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 should treat them as taxable income.

PAIFs

In relation to PAIFs, broadly, for recipients, property income distributions are taxed as profits of a UK property business. UK resident individuals are therefore 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. 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 38.1%) and corporation taxpayers can potentially benefit from the general UK company exemption from tax on dividends.

CoACSs

For income tax purposes, a CoACS is transparent and investors are treated as if they directly received the income arising from its assets. Accordingly, the tax treatment of an investor in relation to this income will depend on the investor’s own tax position.

For capital gains purpose, 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.

5.2 Tax Treaty Network

The UK has one of the world's largest networks of double tax treaties. Whether or not a fund itself can benefit from protection against taxation under the terms of a treaty will depend on various factors, including the terms of the treaty itself and the particular circumstances of the fund. Tax opaque funds may be able to benefit from this protection (for example, an ITC may be able to rely on the terms of a double tax treaty to reduce or eliminate overseas withholding tax which would otherwise apply to dividends or interest it receives).

In relation to certain tax transparent funds, it may be possible for investors to benefit from treaty protection in relation to amounts received by the fund. Whether this protection is available will depend on a number of factors, including, the terms of the relevant treaty and the particular circumstances of the fund and relevant investor.

Generally, the UK does not tax non-resident investors on gains made from investments in UK funds or dividends received from these funds, other than in certain circumstances where the fund invests in UK real estate. In cases where the UK does potentially tax non-resident investors, it may be possible for an investor to rely on the provisions of a double tax treaty to reduce or eliminate this taxation, for example, in relation to withholding tax on a PID paid by a REIT. Whether or not relief is available will depend on a number of factors, including, the terms of the relevant treaty and the particular circumstances of the relevant investor.

5.3 FATCA and CRS Regimes

The UK has entered into a Model 1 Intergovernmental Agreement with the US, which implements FATCA in the UK. Compliant UK funds will not be subject to, nor will they have to operate, any FATCA withholding taxes. The OECD Common Reporting Standard (CRS) and the EU Directive on administrative co-operation in the field of taxation (DAC) have also been implemented into UK law. Relevant UK funds have to carry out due diligence and reporting on their investors under both regimes (FATCA and CRS/DAC), and will then have to report information about these investors to the UK tax authority.

5.4 Tax Structuring Preferences of Investors

The tax structuring preference of an investor will depend on its particular circumstances and the asset class or classes in which the fund invests. Funds will commonly have a wide mix of different types of investors (eg, UK-resident corporates and individuals, sovereign wealth funds and pension funds) and fund managers will 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 a particular investor or class is particularly important).

A key issue for all investors will typically be tax neutrality when investing through a fund (wherever that fund is estab-

lished) ie, they will not want that investment to leave them in a worse tax position than if they directly held the underlying assets. 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 that is typically important for investors when investing in funds (wherever the funds are located), is a wish to minimise withholding taxes on their returns from the fund.

From a UK perspective, an important issue will be whether the fund would be considered to be trading. This can be relevant both at fund and investor level, as, for certain UK fund types and investor classes, their tax privileges 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).

6. Miscellaneous

6.1 Asset Management Industry Bodies

There are a number of key asset management industry bodies in the UK. The British Private Equity and Venture Capital Association ("BVCA") is the industry body for the private equity and venture capital industry. Founded in 1983, the BVCA's membership comprises of investors, fund managers, entrepreneurs and companies, advisers and service providers and represents their interests to government, parliamentarians, officials and regulators, the media and other sections of the business community. Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors, including the UK. Invest Europe is based in Brussels. The Association of Investment Companies ("AIC") is the principal trade body representing listed closed-ended companies in the UK. For open-ended funds, the Investment Association is the trade body that represents UK retail investment managers and promotes UK investment management throughout the world.

6.2 Preference for Courts or Arbitration

Because the UK has a sophisticated judicial system and contracting parties tend to have a high degree of trust in the UK system, fund documents will usually refer to the jurisdiction of the UK courts rather than an arbitration process.

6.3 Level of Litigation/Arbitration

The UK has been one of the leading jurisdictions for investment fund management for a significant number of years and has been one of the leading jurisdictions for requiring regulatory oversight of the investment funds industry. As a result, the level of litigation and arbitration involving the investment funds industry has been relatively low. However,

as a counter-weight to this, it should be noted that the FCA has been increasingly active in pursuing both formal and informal regulatory investigations into investment funds and their managers when the regulator considers that certain activity is not up to the high standards expected within the industry.

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6.4 Periodic Reporting Requirements

Fund managers must comply with a range of detailed regulatory reporting obligations. Broadly, managers will be required to make periodic reports to the FCA in accordance with AIFMD or the UCITS Directive, as the case may be, using a set of prescribed forms. In addition to the annual reports in respect of each managed fund, AIFMs 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). UCITS managers will be required to report on the use of derivatives and also the top five execution venues where it has executed client orders and/or the top five execution venues or investment firms to which the fund manager has transmitted orders for execution.

6.5 Powers of Attorney

If negotiated between the parties, investors are permitted to give powers of attorney in favour of fund managers.