TRAVERS SMITH

The UK Alternative Asset Management Industry

Blueprint for a Bright Future

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WE ARE WHERE WE ARE, SO WHAT ARE WE GOING TO DO ABOUT IT?

The asset management industry is of vital importance to the United Kingdom economy, in terms of UK employment and tax revenues as well as the social, economic and business needs that fund strategies fill. Further, a number of private and listed fund strategies drive investment in other sectors of the economy – from equity investment in trading companies to lending to small businesses to development of infrastructure. We have a world leading constituency of managers, professional advisers and service providers and UK domiciled investors provide significant amounts of capital to a wide variety of investment strategies.

We believe it is of paramount importance to protect and develop the asset management industry in the City of London and the rest of the UK in order to maintain the UK's status as a world leader in the sector and to ensure that the wider economy continues to benefit from the deployment of global capital in investment opportunities in the UK. It is vital that the sector is not only seen as open for business but in fact growing. A number of jurisdictions (both within and outside the European Union) are actively trying to increase their competiveness in terms of attracting the alternative investments asset management sector so with or without Brexit, the UK cannot afford to be complacent in terms of maintaining its market leading position.

As well as the existing infrastructure, there are other attributes of the UK funds industry that can be capitalised on: flexibility, straightforward access to investors, time zone, track record and English law as a valued legal system. These attributes can be enhanced by improving the regime available to fund managers and investors, so that the asset management industry is able to develop further in the UK.

We have set out below a summary of the actions we believe should be taken (most of which are entirely within the control of a UK government, either in the lead up to or post Brexit) to not only maintain the United Kingdom's position in the asset management sector but to enhance it.

Our views, set out in this summary are based on the political and economic position at the end of March 2017. We would also note that while this paper focuses on the alternative asset management sector of the industry, our proposed approach to regulation of the asset management and funds industry set out below could also be applicable to the retail funds sector, albeit with certain modifications to take account of the particular features of the retail fund sector and the current application of the Undertakings for Collective Investment in Transferable Securities Directive (**UCITS**).

ADVOCATING TWO-WAY ACCESS TO THE EU FINANCIAL SERVICES MARKET

Based on the public statements made by the UK Government thus far, we have assumed that following the UK's exit from the European Union in March 2019, the UK will be regarded as a "third country" under EU financial services law.

As already contemplated by the Prime Minister in her objectives for the upcoming negotiations, we strongly advocate that the withdrawal treaty should ensure that there is an appropriate transitional period for financial services regulation to avoid a regulatory "cliff edge" in the immediate lead up to exit and that the UK is determined on the day of Brexit as having a legal and regulatory framework "equivalent" to the EU in all respects under all relevant EU financial services laws (most notably, in the private and listed fund management context, the Alternative Investment Fund Managers Directive (**AIFMD**) and the Second Markets in Financial Instruments Directive (and Regulation)).

Whilst it remains unclear precisely how equivalency will operate in the context of these Directives (not least because anticipated developments in this area, such as the AIFMD third country passport, appear to have been put on hold by the Commission in order to not prejudice its negotiating position with the UK), we would hope that negotiations on the UK's exit do not become so contentious that UK asset managers are treated any differently to, for example, asset managers located in the United States or the Channel Islands.

We would also, in the context of the AIFMD, advocate lobbying for EU jurisdictions to retain national private placement regimes in key jurisdictions for as long as possible (if not indefinitely) so that UK alternative investment fund managers (**AIFMs**) who do not wish to conduct activities in the EU are still able to access European investors and capital.

Similarly, in the context of the mainstream, retail investment market the withdrawal treaty should ensure that the UK UCITS funds continue to be recognised as suitable investment vehicles for retail investors and the existing passporting rights available under UCITS are retained.

However, there are a number of managers that carry out their management activities solely in the UK and/or outside the EU and which have funds that are not marketed within the EU other than the UK (or are only marketed there to a very limited extent). For these managers and their funds, with an appropriately sensitive and balanced regime, the UK should become the jurisdiction of choice for either or both of basing their management operations and/or acting as the home jurisdiction of their fund structures.

THE UK FRAMEWORK FOR FUNDS AND MANAGERS THAT DO NOT NEED TO ACCESS EU PASSPORTS

In order to achieve the status of a market leading jurisdiction for managers that are not managing EU funds or marketing under the passport (if available) to EU investors, we believe a revised and, in certain respects new, legislative and regulatory framework sitting alongside the EU equivalent regime needs to be established. This regime should be based around the following three principles:

- The UK regulatory framework for asset managers operating in the UK or managing UK funds from outside the UK should be proportionate, tailored, flexible and competitive, whilst providing for appropriate levels of investor protection. Further, the tax rules applicable to UK managers should be clear, fair and set at a competitive level that reflects the benefits of the asset management industry to the wider UK economy. To be clear: we are not proposing an indiscriminate "bonfire of regulations", but targeted rules that would be better adapted to the particular industry sector and would avoid unnecessary costs and complexity.

- The United Kingdom should have a range of fund structures available that provide appropriate flexibility for private, listed and open-ended retail structures which can be used across all asset classes.

- There should be no material barriers to investment in UK fund structures by investment professionals from around the world. Further, the regime in place should encourage international investors to establish a base in the UK.

In addition, we would advocate a clear, coherent and stable tax regime, as summarised below, which would be applicable to both managers, regardless of whether they are impacted by any EU equivalent regulatory regime.

Further details on how we see each of these aims being implemented is set out below.

A. The UK being a leading jurisdiction for domiciling asset managers

For asset managers operating in the United Kingdom or overseas asset managers managing or advising UK domiciled funds, the UK regulatory regime should provide an appropriate level of oversight in a manner that does not impinge on the operation of a manager's business for the sake of it and which is quick to respond to market developments.

With this in mind, we would advocate the following:

- UK based private and listed fund managers who do not wish to access the AIFMD third country passport should not require authorisation as an AIFM but should instead be subject to a domestic regime which is no more onerous than the one which preceded AIFMD. Prior to AIFMD, such managers were required to be authorised either as the operator of a collective investment scheme (**CIS**) (where they managed the fund) or as a sub-manager or an adviser/arranger to a substantive offshore (e.g. Guernsey or Cayman) manager.

- For managers that are already regulated in other jurisdictions where we believe there is a level of equivalence with our regulatory regime (the EU member states, the United States and Singapore being immediately identifiable examples) and who wish to establish operations or branches in the United Kingdom, there should be a fast track process for being approved to carry on the relevant regulated activities in the UK, taking account of those managers' existing regulatory approvals.

- A new exemption could be introduced under FSMA the effect of which would be to permit a US foundation, an Asian sovereign wealth fund, or a European insurer (for example) to establish a team in an office in the United Kingdom, which need not be FCA authorised provided its sole function was to engage with regulated (UK and global) fund managers with a view to deploying capital with them.

- Pay regulation for asset managers should not be imposed. Investors care about the amount of money paid by the fund to its manager as this directly impacts the fund's net asset value and return profile. It should be for investors to decide whether or not they accept the manager's overall approach in determining whether or not to make an investment and fee levels already form part of negotiations between investors and managers prior to investment.

- Whilst the elements of the AIFMD regime that provide meaningful investor protections could be replicated in the new UK regime, a number of the provisions that are seen only as generating additional cost and process without any real additional investor protection should be removed. For example, our initial view is that the professional investor community would not demand repetition of the depositary rules in any dual track UK regulatory regime for institutional fund managers that do not wish to avail themselves of the passport in the vast majority of asset classes.

- We would also advocate a simplification of the regulatory capital requirements applicable to private (and where, applicable, listed) fund managers. A major cost of doing business for regulated firms is the minimum capital requirements to which they are subject, which act as a constraint on their establishment and growth. We would suggest a lighter touch but proportionate regulatory capital regime for such fund managers than that which currently applies to above threshold AIFMs.

- Implicit in adopting these alternative proposed regimes would be reverting to widely understood UK domestic criteria for whether capital qualifies as regulatory capital, rather than the current complex requirements of the EU Capital Requirements Regulation (which is currently also incorporated into the AIFMD regime). We also believe that the current requirement for certain firms (for example, MiFID portfolio managers) to produce Pillar 3 disclosures could be abolished. These documents are often costly to produce, but in the asset management context they have little or no appreciable effect on market discipline. We also suggest removing the liquid assets requirement that currently applies to AIFMs, which has a distorting effect on competition given that other types of firms are not generally subject to such a requirement.

- We do not think that the AIFMD's anti-asset stripping requirements should be incorporated into any domestic regime. In our view, they can lead to inefficient deal structuring (which has the potential to lead to adverse impacts on investor returns) and discourage entrepreneurship without any commensurate increase in investor protection.

- While we recognise the importance of appropriate regulatory oversight of funds and fund managers, we think that regulatory reporting by such managers could be simplified. The current Annex IV reporting regime introduced by the AIFMD is unnecessarily complex and is not well adapted to cover the multitude of different types of managers and funds.

- The current material change regime introduced by the AIFMD is, in a closed-ended fund context, disruptive to the fund raising process and frequently requires one-month wait periods following the notification of proposed changes before they can be actioned. This situation has been compounded by the implicit or explicit labelling of certain changes as “material changes” under AIFMD, even though many investors would consider those changes to be insignificant (for example, the change of a fund's name for technical reasons). The fund raising process could be made considerably more efficient if the material change requirement was abolished or replaced by a more appropriate, proportionate regime.

- The FCA (or UKLA where applicable for listed funds) being permitted to provide binding advance regulatory clearance for fund structures (including in respect of eligibility for listing in respect of proposed listed funds strategies).

- A commitment to reduce the frequency of changes to the revised regulatory regime (in other words, a stronger commitment to the cost/benefit analysis of making changes).

- We would suggest that a provision similar to that in Article 51ZG of the Regulated Activities Order (which provides that a person does not carry on the regulated activity of establishing, operating and winding up a CIS if the person carries on the activity in relation to an AIF which is managed by a UK authorised or registered AIFM) is introduced. Such a provision would make clear that if a CIS is already managed/operated by a person with the establishing/operating/winding up a CIS permission that no other person also carries on that activity. This would eliminate the risk that in limited partnership fund structures, the general partner may be carrying on this regulated activity in addition to the FCA authorised manager.

B. UK fund structures

The UK should have a range of available fund structures that can be used across all investment sectors to invest in strategies that provide a tax efficient result for investors. In particular, we would recommend the following:

- After the welcome introduction of the Legislative Reform (Private Fund Limited Partnerships) Order 2017 to introduce a more up-to-date and competitive fund structure for the UK, we would suggest further changes to limited partnership law should be pursued as a matter of urgency, for example, giving all private fund limited partnerships, including English limited partnerships, the ability to opt for separate legal personality; and abolishing the Partnership Accounts Regulations (which derive from a European directive). Adopting this approach would also enable direct lending funds to be located in the United Kingdom in circumstances where they are managed by UK asset management groups addressing one of the key concerns for the UK funds industry arising out of the BEPS project (further information on which is set out below).

- The investment trust rules for listed investment companies already provide for an effective structure for listed funds. However, in terms of the requirements for listing, the existing Listing, Prospectus and Disclosure and Transparency Rules should be revised to further streamline the listing process and documents produced in connection therewith. In particular, we would advocate:

  - revisions to the summary rules for prospectuses in order that they provide a useful summary of the key terms and investment considerations (in place of the PRIIPS rules which are currently due to come into effect later this year);

  - extending the existing "tap issue" exemption to admitting shares without a prospectus to 20 per cent. of the existing share capital in any 12 month rolling period as is currently proposed under the Prospectus Regulation;

  - providing for a "shelf prospectus" regime whereby secondary offers by listed funds only require the approval of a short form prospectus including the terms of the offer being made and an update on the underlying fund portfolio. This could also be accompanied by a corresponding reduction in approval times by the UKLA for draft prospectuses; and

  - a review of the rules on disclosure in respect of investments representing more than 20 per cent. of a listed fund's portfolio to make the disclosure included in the prospectus more investor friendly rather than formulaic.

  Changes to these rules would also further enhance the use of real estate investment trusts (**REITs**), potentially triggering further investment into UK real estate.

- The establishment of a tax exempt corporate fund structure – the addition of such a structure to the range of UK vehicles would allow the UK to compete with equivalent EU domiciled vehicles, including those in Ireland and Luxembourg. In the listed fund context, we would argue such a structure should be in addition to the existing investment trust regime and not a replacement for it.

- A review of the existing "Non-UCITS Retail Investment Scheme" (**NURS**) rules should be carried out to ensure that UCITS equivalent strategies for UK and other non-EU retail investors can be implemented in, and managed from, the UK.

- A review of the existing "qualified investor schemes" regime for authorised funds restricted to professional and sophisticated investors should be carried out to determine how to make this a more attractive vehicle for institutional investors and managers alike. Consideration should also be given to the regulatory approach to authorisation for these types of funds. Speed to market is essential and other jurisdictions like Ireland and Luxembourg have fast track regulatory approval processes enabling a much quicker overall fund launch programme.

- Consideration should be given as to whether specific regulations applicable to securitisation and loan origination funds should be provided for under the revised UK regulatory regime. In particular, we would hope that such regulations expressly provided for the ability of closed-ended funds to be able to originate and acquire loans. We anticipate that debt funds will continue to perform an increasing role and regulatory certainty as to their establishment in the UK would be welcomed. It is likely that European rules will be adopted over the coming years to govern the operation of loan origination vehicles on the continent and the UK should have a competitive fund structure as compared to what is eventually permitted in the EU whilst appropriately managing any related systemic risk issues.

- Additional specific regimes for different asset classes which act as an overlay on the chosen underlying fund structure could be considered where it is thought appropriate to do so. For example, new technology, fintech and life sciences strategies could be considered in this regard.

In addition to the points above, we will need to closely monitor how the UK's new relationship with the European Union impacts on the use by UK or Channel Islands funds of holding company structures in the EU (which will also interplay with the implementation of the BEPS substance requirements).

C. Investment into UK funds

The marketing laws applicable to UK fund structures (such as financial promotion rules, the replacement for the Prospectus Rules in respect of listed funds and any reverse solicitation rules) must include sufficient flexibility to permit investment in UK listed funds and private funds by UK institutional investors and institutional investors from outside the UK.

Whilst it is not within the control of the UK government to dictate the marketing restrictions that apply in overseas jurisdictions to the marketing of a UK fund, our laws should permit investment by investment professionals and marketing to such professionals to the extent they have a presence in the UK. If the UK is able to attract institutions with available capital to have a base in the UK and the process of marketing to such institutions is not onerous, then asset managers (and the associated infrastructure) will follow.

The UK's current financial promotion and fund marketing regime for private funds could be simplified. For instance, firms should be able to market private funds to ultra-high net worth individuals and family offices.

The introduction of a new category of 'sophisticated' investor would provide a much needed layer of flexibility and better represent the diversity of investors. This would not damage investor protection since there would still be the requirement to ensure that the investor had appropriate knowledge and experience to understand the risks involved before they invested.

TAX REFORM

In addition to the proposed changes to the regulatory framework applicable to private and listed managers operating in the UK set out above, the tax regime applicable to them (as well as the UK authorised/equivalent AIFMs) should also be competitive. While there exists significant opportunities to build on current market strength and positioning the UK as an attractive jurisdiction for investment managers and fund domicile, this will not happen without a competitive tax regime. The desired outcome for the industry should be a clear, coherent and stable tax regime that is able to compete directly with other jurisdictions such as Ireland and Luxembourg, backed by a supportive tax authority. The following examples are issues that could be addressed from the outset:

- The UK's departure from the EU will have significant VAT implications for businesses and will require a fundamental review of how VAT should operate going forwards. Given that VAT is the second biggest source of tax revenue, we assume that VAT will remain in some form. In the context of the investment funds industry, certain UK based funds (particularly those structured as limited partnerships) are currently at a disadvantage to their counterparts in Luxembourg, Ireland and the Netherlands. This is because the primary VAT Directive provides that member states should exempt the management of "special investment funds" but member states are given discretion as to how "special investment fund" should be defined. The UK has interpreted "special investment fund" narrowly meaning that the supply of management services to such funds are subject to VAT at the standard rate. Whilst the UK has been obliged to widen the types of entities that qualify as special investment funds following a series of EU cases, the exemption is currently only available for investment trusts, venture capital trusts and non-UK funds which are recognised by the FCA as equivalent to UK regulated funds. As things stand, the UK has not included real estate funds (unless they fall into the categories above) or private equity limited partnerships. As such, management and advisory services provided to such funds are currently standard rated supplies. The UK should broaden the scope of the management of special investment funds exemption. Competition with the EU will only become fiercer as a result of Brexit and one of the key requirements to compete with the likes of Ireland, Luxembourg and the Netherlands (for example in relation to private equity and other fund structures as well as on products such as securitisation and collateralised loan obligation structures) is an even playing field where such jurisdictions already have wide exemptions. In addition, widening the exemption may assist with various asset classes being brought back onshore if the UK loses its regulatory passport, and EU structures lose the ability to market to UK investors.

- In the last 2 years, investment managers have had to keep pace with an unprecedented wave of new legislation which has resulted in a complete overhaul of the taxation of their returns. Investment managers have witnessed the introduction of the salaried member rules, the mixed membership partnership rules, the disguised investment management fee rules, the abolishment of the "base cost shift" for carried interest, the exclusion of the new 20% capital gains tax rate for carried interest and the introduction of the income based carried interest rules. Whilst being cognisant of the current fiscal pressures on the UK economy as a whole, certain of these rules have been made hastily with little effective consultation as to their consequences. The introduction of any further rules impacting the investment management industry could be a disincentive for international management groups to retain UK offices or to carry on any activities from those UK offices which are not strictly related to UK or European funds. In order for the UK to continue to be the leading centre for fund management, it is imperative that strengthened trust between HMRC and the investment management industry is developed. As a starting point, we would recommend that no further changes are made to the tax treatment of investment managers' returns which could have a negative impact.

- Connected with the above are the issues of certainty and predictability. Certainty and predictability about the direction of tax change is a key issue in ensuring that the UK has an attractive regime for investment managers and fund domicile. The major international influence on the UK tax system over the next few years will likely be the OECD's project on base erosion and profit shifting (**BEPS**). In the context of investment funds, the most significant BEPS actions are likely to include Action 2 (measures designed to neutralise the effects of "hybrid mismatch arrangements"), Action 4 (the introduction of rules to limit the availability of interest deductions for debt), Action 6 (proposed changes to double tax treaties to prevent treaty abuse) and Action 7 (proposed changes to the treaty definition of "permanent establishment" to expand significantly the scope of activities that may be treated as giving rise to a permanent establishment). The UK took unilateral action by introducing the Diverted Profits Tax. The UK has also introduced rules to neutralise the tax effects of hybrid mismatch arrangements from January 2017 and is proposing to introduce rules to limit interest deductions for businesses from April 2017. Anti-avoidance policy has greatly exacerbated unpredictability in the development and application of tax policy in recent years. The manner in which highly complex anti-avoidance legislation is introduced has been problematic, with many changes being made piecemeal and without sufficient notice or consultation. It is essential that the direction of tax policy should be stable and clear, and rule changes subject to proper consultation and debate. We would strongly recommend that the implementation of the new BEPS related rules (particularly those relating to limiting the availability of interest deductions) should be delayed in order to give businesses sufficient time to prepare, particularly given the economic uncertainty thrown up by Brexit.

- One of the key components in the UK’s continuing attraction for non-resident investors is their ability to appoint UK-based investment managers without creating a risk of UK taxation for themselves. This is achieved through the UK's investment manager exemption. Foreign investors are unlikely to bring their business to the UK if there is a real risk that the investment returns on their portfolio managed by the UK based investment manager might be subject to UK tax. Although the favourable treatment offered by the investment manager exemption is no doubt only one factor amongst many which has helped the UK to maintain its competitive edge, it is imperative that the exemption is maintained particularly in light of any revisions made to the permanent establishment rules as a result of BEPS.

- The UK should have a range of available fund structures that can be used across all investment structures to invest in strategies that provide a tax efficient result for investors. This is not a matter of tax avoidance but should be about ensuring that investors do not suffer tax that they would otherwise not have to pay had they invested in the underlying assets directly. The tax-efficiency of the fund vehicle is, therefore, paramount in ensuring that investors pay the right amount of tax.

WHAT WE CAN DO

We would welcome any thoughts our colleagues in the industry, commentators or politicians may have on our proposals set out above.

Inevitably the political landscape will change over the coming months and years and the future of the UK asset management and funds industry will be impacted by that. We also expect a number of managers to establish bridgeheads in Europe for their operations in order to continue business as usual given the uncertain circumstances. That said, whilst many would not have wanted to be in this position, Brexit potentially creates a once in a generation opportunity to look at the regulation and tax framework of the UK asset management and funds industry in order to create a legal and regulatory regime that is additive to the world leading managers, advisers and infrastructure that is already located here, which could ultimately be of benefit for all to all stakeholders in the sector.

If you would like to discuss any of the issues raised in this briefing, or if you think Travers Smith could assist you in respect of any industry discussions, please do not hesitate to contact your usual contact or any of the partners named below.

ABOUT TRAVERS SMITH

Travers Smith is an international law firm with a market-leading investment funds and asset management practice.

The core areas of our practice are Private Funds and Closed-ended Listed Funds.

Our Investment Funds Group brings together fund formation, regulatory and tax expertise in an integrated practice focusing on funds work (both private and listed) within the private equity, real estate, alternative credit, infrastructure and listed equities sectors.

Our Private Funds' work covers fund formations from innovative funds through to funds for global asset managers. We also act for institutional investors on their participation in funds, including large institutional investors such as pension funds, funds of funds and family offices.

Our Closed-Ended Listed Funds' work covers IPOs on all London markets, secondary issues, reorganisations and M&A. We have built an impressive and highly regarded practice acting for listed funds and sponsors alike including a market leading practice in listed alternative credit strategies.

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