BRIEFING

The UK Alternatives Asset Management Industry Blueprint for a Bright Future

September 2020

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, now more than ever as the economy seeks to recover from the financial impact of the COVID-19 pandemic.

The sector is a significant contributor to UK employment and tax revenues as well as the social, economic and business needs that fund strategies fill. Fund strategies drive investment in key sectors of the economy – equity investment in trading companies and real estate entities, provision of private capital to market-disrupting technology growth businesses, lending to small businesses, development of infrastructure and housing, to name but a few. They are also increasingly at the forefront of the implementation of the green economy and sustainable finance agenda.

We believe it is of paramount importance to protect and develop the alternatives asset management industry in the UK following our exit from the EU 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 and through 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 competitiveness and attract aspects of alternatives business so, regardless of Brexit, the UK cannot afford to be complacent in terms of maintaining its market leading position. Standing still is likely to result in going backwards.

HOW DO WE ACHIEVE THIS?

There are already a number of factors that work to the UK's advantage. We have a world leading constituency of managers, professional advisers and service providers. UK investors (especially pension funds), in addition, provide significant amounts of capital to a wide variety of investment strategies and many large non-European investors also like to use the UK as a base from which to operate. Alongside its existing infrastructure, the UK's flexibility, straightforward access to investors, time zone, track record and English law as a valued legal system can be capitalised on. However, the UK can build on these advantages by improving the regime available to fund managers and investors and enabling further development of the asset management industry.

This paper sets out a summary of the actions we believe should be taken, not only to maintain the United Kingdom's position in the alternatives asset management sector, but to enhance it.

EUROPE AND EQUIVALENCE – WHAT DO WE ACTUALLY WANT AND NEED?

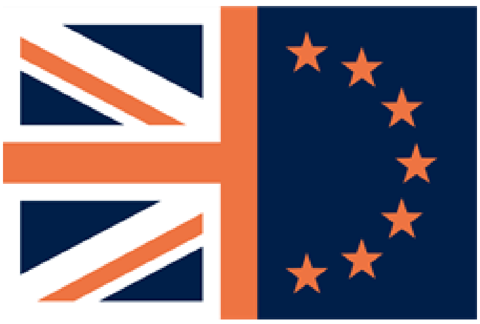
Before we focus on what we believe the UK government should be doing, we, of course, need to consider what impact the UK's future relationship with the EU will have on our ability to shape the regulation of the asset management sector going forward.

It is now clear that the UK will be regarded as a "third country" under EU financial services law following the end of the Brexit implementation period.

As the debate over the future trading relationship with the EU continues over the remainder of 2020 (and potentially beyond), in the financial services context, a lot has been, and will continue to be said about whether the UK will have (or be deemed to have on a continuing basis) a legal and regulatory framework "equivalent" to the EU in all respects under all relevant EU financial services laws. Most notable, in the alternatives asset management context, are the Alternative Investment Fund Managers Directive (AIFMD) and the Second Markets in Financial Instruments Directive (and Regulation) (MiFID II).

It is worth considering how important maintaining an equivalent status really is and what the implications would be if we were to seek equivalence at all costs.

Starting with the latter question, if we assume that the EU will not accept that equivalence in our regimes today will constitute equivalence for a set period (the EU's current position), the UK may well be required to update its own law and regulation to track future changes to EU law (to some extent). This may not be something the UK wants to do bearing in mind it will not be "in the room" when it comes to agreeing such EU legislation. Indeed, seasoned (and for that matter Europhile) UK representatives who represented EU institutions in the UK's prior life as a full member state have publicly stated that the UK acted as a sensible brake on a number of pieces of existing legislation that could have otherwise potentially damaged the industry. There are any number of areas that could come within the scope of new or refined EU legislation in the future (not all of which the UK asset management industry will approve of) – pay regulation for asset managers and the financial transactions tax to name but two. As such, maintaining equivalence is not without its risks, so what is the benefit?



Equivalence may be important to the alternatives asset management sector in the event that the AIFMD "third country passport" is turned on in the future. The advantage of accessing the marketing passport, if it is ever turned back on, will be accessing EU professional investors without having to navigate the various private placement regimes in place across member states. However, a UK manager that accessed the third country passport would also become subject to oversight of an EU regulator and be subject to the full scope of applicable AIFMD rules. There is an open question on whether the passport will ever be made accessible to managers located in third countries but assuming it is, would this really make a material difference to how UK based managers are operating already?

Whilst access to a marketing passport would have benefits around ease of marketing throughout the EU, the prolonged Brexit process has meant that most UK domiciled managers have already put in place arrangements to replace the loss of the marketing passport for UK regulated entities following the end of the implementation period. This has been achieved through the establishment of an AIFM within the EU (most commonly in Luxembourg or Dublin) or relying on relevant national private placement regimes (which have proven satisfactory for US and Channel Islands funds). While there are still complications that are being worked through (including the roles of sales/IR teams located in the UK), neither of these models should be directly impacted by any ruling of (or absence of) equivalence between the UK and EU regulatory regimes.

On balance, to the extent there is a third country passport under AIFMD in the future, it is something the UK should look to access. But, we would argue, this should not be at all costs, particularly in terms of any changes the UK would be required to make to its post-Brexit regulatory regime. In any event, we would hope that negotiations on the UK's future relationship 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 in terms of their access to the national private placement regimes.

However, in order to avoid a significant outflow of business from the UK, it is essential that UK firms are able to provide advisory and arranging services (and increasingly delegated portfolio management services) to EU AIFMs. The current expectation is that UK affiliates of EU AIFMs will continue to be able to provide advisory and arranging services to the EU AIFMs within their corporate group, given that most member states do not require a licence for this (although this could change in the future). The position may differ in respect of advisory and arranging services provided to a third-party manager that is not an affiliate. Further, while there may be regional variations, it should generally be possible for a UK firm to be appointed as a delegated discretionary portfolio manager by an EU AIFM, provided that a memorandum of understanding (MoU) is in place between the UK and the AIFM's home jurisdiction. In this respect, the recent announcement of an agreed MoU between the UK and ESMA is to be welcomed.

As such, it is not currently expected that the delegation of services to UK firms is under threat, but the EU's default position could change in the future and this would have a significant, adverse effect on the UK alternatives industry. This risk would be largely mitigated if the UK were to secure MiFID II third country equivalence (as well as removing some practical hurdles that are likely to need to be addressed in the context of the provision of services from the UK to the EU, including in respect of the delivery of certain marketing activities related to funds under management).

It is worth noting that views on the importance of equivalence will vary across the wider UK asset management industry. For example, in the context of the mainstream, retail investment market, any UK/EU treaty should ideally 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. Further, in the alternatives sector, the entry into EU cross border derivates will certainly be simpler in the event that equivalence is maintained.

To the extent that the wider industry does require equivalence, we would argue that the UK regulatory regime should provide sufficient flexibility for UK alternatives asset managers to not have to comply with aspects of the regulatory regime that are solely there to enable an equivalence agreement with the EU (i.e. they only comply with relevant additional requirements if they want access to a passport). If UK managers do not require access to the passport, the UK should provide a specific and tailored regime that is attractive to alternatives managers around the world which provides investors and counterparties with protections that are effective but are not regulation for regulation's sake. Our suggestions on what this could look like are described below.

THE UK ALTERNATIVES ASSET MANAGEMENT INDUSTRY – A BEST IN CLASS FRAMEWORK TO MATCH OUR BEST IN CLASS INDUSTRY

In order to achieve the status of a market leading jurisdiction for alternatives managers, we believe a revised and, in certain respects new, legislative and regulatory framework 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. 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.
- We would advocate a clear, coherent and stable tax regime for asset managers and their funds.

Further detail 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 without good reason and which is quick to respond to market developments.

With this in mind, we would advocate the following:

- UK based fund managers who do not wish to access the AIFMD third country passport (should it come into existence) should not require authorisation as an AIFM but should instead be subject to a domestic regime which is tailored to, and appropriate for alternatives asset managers which equally provides appropriate and focussed investor protections.
- 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 view is that the professional investor community would not demand repetition of all of the depositary or reporting rules in any UK regulatory regime.
- 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, return profile and alignment with investors. 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 (including the basis on which fees are dependent on the success of the fund overall).
- We would also advocate a simplification of the regulatory capital requirements applicable to fund managers and, especially, advisers to such 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 (or is expected to apply to MiFID portfolio managers under the new prudential regime for investment funds).
- 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 and expected to be replicated in the new prudential regime). We also believe that the current requirement for certain firms (for example, MiFID portfolio managers) to produce Pillar 3 disclosures – which is proposed to be largely retained in the new prudential regime – 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.
- The AIFMD's anti-asset stripping requirements should not be incorporated into any domestic regime. In our view, they 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 believe that regulatory reporting by such managers could be simplified. The current Annex IV reporting regime introduced by 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 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 either insignificant (for example, the change of a fund's name for technical reasons) or investor friendly. 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.
- We would suggest that a provision similar to that in Article 51ZG of the Regulated Activities Order is introduced. This provides that a person does not carry on the regulated activity of establishing, operating and winding up a collective investment scheme ("CIS") if the person carries on the activity in relation to an AIF which is managed by a UK authorised or registered AIFM. Such a provision would make clear that, if a CIS is already managed/operated by a person with the establishing/operating/winding up CIS permission, 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.
- 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.

- We would propose that the government considers whether the risk mitigation techniques under the UK's onshored version of EMIR (in particular the requirement for AIFs to exchange collateral as margin in respect of most derivatives) remain fit for purpose. Given that many alternatives asset managers (with the exception of hedge funds) use derivatives solely for risk mitigation, and not for speculative purposes, the cost and operational burden placed upon managers by the risk mitigation requirements may dissuade those managers from prudent risk management (thereby increasing risk within the UK alternatives asset management industry). In particular, we would propose the government considers exempting a broader range of asset classes from the requirements to post and receive variation margin as collateral (at present, only physically settled FX forward and swap transactions are exempt from these requirements). Further, consideration should be paid to whether the use of derivatives by AIFs to mitigate FX risk should be considered as leverage, given the corresponding impact on managers of leveraged funds. These two points are linked by the desire to avoid an unleveraged fund becoming a leveraged fund (solely as a result of hedging FX risk) may dissuade managers from undertaking prudent risk management.
- There should be greater clarity around the perimeter of the Securitisation Regulation (as implemented into UK law) in order to reduce the risk that funds constitute accidental securitisations.
- The FCA being permitted to provide binding advance regulatory clearance for fund structures (including in respect of eligibility for listing in respect of proposed investment company strategies).
- The FCA should be given more resource in order to be able to determine an application (for example, for new authorisation or approval of senior managers) much quicker. Applications are currently regularly going beyond statutory deadlines.
- 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).

B. UK FUND STRUCTURES

The UK should have a range of fund structures that can be used across all investment sectors to invest in strategies that provide a tax efficient result for investors Providing a range of competitive UK fund vehicles is about ensuring that the right amount of tax is paid, rather than tax avoidance. In particular, we would recommend the following:

- Limited partnership vehicles remain a very important structuring option for the asset management industry and many funds are structured as limited partnerships. The UK limited partnership has, historically, been a "go-to" vehicle for both domestic and international asset managers. However, the use of UK limited partnerships has been declining, as other jurisdictions (particularly Luxembourg) have developed and improved their own limited partnership laws. The UK has, therefore, been falling behind its competitors. In recent years, a number of helpful changes have been made to the UK's limited partnership law, in particular the introduction of the private fund limited partnership regime. However, a further consultation process remains open to address perceived weaknesses in the law that has allowed limited partnerships (particularly Scottish limited partnerships which have separate legal personality) to be used for money laundering and other criminal activity. In particular, the UK Government has been exploring whether the strike-off process can be improved and whether all UK limited partnerships should be required to maintain an identifiable connection to the UK. We support changes being made to the UK limited partnership law, provided that the changes are proportionate and take account of the requirements of the asset management industry. In particular, we would suggest there is a renewed focus on making the UK limited partnership the best in class of its type. For example, other changes that could be considered are simplifying the distinction between English and Scottish limited partnerships so that there is a more uniform approach across the UK, giving all UK limited partnerships the ability to opt for separate legal personality, and abolishing the Partnership Accounts Regulations (which derive from a European Directive).
- There are gaps in the current UK domiciled fund structure offering. In particular:
  - A tax exempt corporate fund structure (or such a structure with a targeted participation exemption) is an obvious gap in the UK's range of structures – 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 investment company context, we would argue such a structure should be in addition to

the existing investment trust regime and not a replacement for it.

- A large amount of investment in UK real estate is made through offshore (commonly Jersey) property unit trusts (JPUTs). This use of an offshore structure gives rise to extra administrative costs and legal complexity as well as diverting associated advisory and support work away from the UK. However, there is no equivalent UK vehicle that provides a tax efficient alternative. It is for this reason that the Association of Real Estate Funds has recently proposed a new form of flexible onshore contractual fund vehicle for professional investors (the professional investor fund (PIF)) to provide a domestic equivalent to the JPUT. We recommend that the UK Government give serious consideration to this proposal.
- A new form of vehicle for debt investment, providing both regulatory and tax efficiency should be introduced. Currently, the UK lags behind other fund jurisdictions in being unable to offer such vehicles e.g. the Irish s110 company or Luxembourg securitisation company or fund. We understand that governmental thought has been given to such a vehicle being a corporate and/or fund structure. The corporate vehicle may be more straightforward, in that the UK corporation tax regime already provides for tax-preferred "securitisation company" status and it is likely to be easier for a corporate to be able to benefit from the UK's existing tax treaty network, significantly increasing its ability to receive foreign source interest free of withholding tax. Whichever form of vehicle is chosen, it will be important that it has the ability to originate and acquire loans and to receive returns with no or minimal tax leakage (something that is already possible for UK securitisation companies) as well as returning profits to investors free of UK withholding tax.

- The investment trust rules for listed investment companies already provide for an effective structure for UK domiciled listed funds. However, in terms of the requirements for listing, the existing Listing Rules, Prospectus Regulation and Disclosure Guidance 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 PRIIPS rules which lead to, in many cases, a false description of future performance to investors and, currently, do not provide for a level playing field between listed investments companies and their open-ended retail competitor funds (this point is also relevant to partnerships in the context of their employee and friends and family participation);
  - providing for a "shelf prospectus" regime whereby secondary offers by investment companies 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 an investment company'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.

- 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 provide 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 in providing finance, regulatory and tax 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. The UK's position could be further enhanced if a tax-efficient debt fund vehicle were introduced and this is discussed further under the "Tax Reform" heading (below).
- 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).

Although not directly relevant to this paper, consideration should also be given to amendments to the authorised funds regieme in the UK. For example:

- 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. We have been part of the discussions on the new Professional Investor Fund proposed by The Association of Real Estate Funds (AREF) and The Investment Association (IA) and support the industry need for such a flexible vehicle in the UK for institutional and similar investors for whom the very prescribed requirements of the current UK regulated funds can be unattractive and a deterrent commercially.

C. INVESTMENT INTO UK FUNDS

The marketing laws applicable to UK fund structures (such as financial promotion rules, the replacement for the Prospectus Regulation in respect of listed investment companies and any reverse solicitation rules) must include sufficient flexibility to permit investment in UK domiciled funds by UK institutional investors and by 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 partnerships could be simplified. For instance, firms should be able to market limited partnerships 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 managers operating in the UK set out above, the tax regime applicable to them should also be competitive. The UK Government's well-intentioned spending measures in relation to the Covid-19 pandemic make it all but inevitable that UK taxes will rise and then stay at those increased levels for a prolonged period. However, that should not prevent the UK from becoming a more attractive location from a tax perspective for the asset management sector. 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.

In this regard, the review of the UK's fund regime announced by the UK Government at its March 2020

Budget (the "**Fund Review**") is extremely welcome. The review is to cover taxation and relevant areas of regulation with a view to consider the case for policy changes. The timetable has been pushed back due to the Covid-19 pandemic and so it is currently not entirely clear how wide-ranging it will be. We would certainly recommend that it has the broadest possible remit, so that all issues relevant to the coherence and competitiveness of the UK asset management sector can be considered and addressed at one time. What we have seen so far looks promising, with the UK Government seemingly open to creative ideas that will give the UK an opportunity to stand out from its competitors. Fund managers increasingly have more than one strategy and are increasingly looking more globally and across asset classes. There are cost savings in scale and ideally the UK should have a product that facilitates global investment. The British Property Federation (**BPF**) in its response to the Fund Review on alternative holding companies (**AHCs**) has provided some figures for the potential costs and social benefits to the UK of an improved, attractive AHC regime.

The following examples are areas that could be addressed in a reform of the taxation of the UK asset management industry:

- The UK should provide a competitive regime for holding company structures used by funds. Although the UK tax regime already has several attractive features for holding companies (for example, a wide-ranging exemption from corporation tax on dividends, an extensive double tax treaty network and no withholding tax on dividends (other than for certain property funds)), in practice it is rarely used by non-UK domiciled funds or for UK funds with non-UK assets. The good news is that this is something that the Government recognises and is already consulting on as part of the Fund Review. However, it will be important that reform proposals do not just focus on tax efficiency, as simplicity and ease of application are also key advantages of competitor jurisdictions (most notably Luxembourg). Providing an attractive holding company regime is not a matter of tax avoidance but, rather, should be about ensuring that funds (and therefore, indirectly, investors) do not suffer tax that they would otherwise not have to pay had they invested in the underlying assets directly.
- The scope of the VAT exemption for fund management services is currently unclear with different states taking differing views and EU case law not providing a coherent set of principles. Only management of a certain type of fund, a "special investment fund" (SIF), comes with the exemption. As discussed further below, there is a lack of clarity in relation to both to the meaning of SIF and what constitutes "management". Brexit should provide the UK with the opportunity to consider this area afresh, allowing it to adopt a more coherent approach than its European competitors. Again, the good news is that the UK Government has said that the treatment of VAT on fund management fees will be within the scope of the Fund Review. However, care will need to be taken here as changes to the scope of the exemption could create losers as well as winners within the asset management sector. Perhaps some optionality could be permitted to reflect the needs of different businesses.
    - The primary VAT Directive provides that member states should exempt the management of SIFs but member states are given discretion as to how SIF should be defined. Currently, the UK takes a narrow view that has the effect of excluding private equity limited partnerships and unlisted unregulated credit funds. By contrast, the competitor EU jurisdictions of Luxembourg, the Netherland and Ireland interpret SIF far more widely, with the effect that supplies of management to relevant funds can be made VAT free. However, the question of whether the UK's narrow definition of SIF should be reformed is not straightforward. Widening the definition would bring more UK funds within the scope of the exemption but would adversely affect UK fund managers that would no longer be able recover their own input VAT on supplies to equivalent funds located outside the UK. An ambitious possibility here would be for the UK to broaden the scope of the exemption in relation only to UK established funds. An important aspect of this extension would be that it would not endanger UK fund managers' ability to recover VAT on management supplies to non-UK funds. Such an approach would allow the UK to compete with the likes of Ireland, Luxembourg and the Netherlands as a jurisdiction for fund domicile whilst not endangering its attractiveness as a jurisdiction for fund managers. Of course, VAT is not an issue in all industries – in particular for mainstream real estate (other than in residential, healthcare etc.), VAT is generally entirely recoverable. Such an exemption would be unattractive to many managers and providers in the sector. These concerns have, we understand, already been taken into account and reflected in the latest iteration of the UK exemption.
    - A probably simpler area of reform would be for the UK to provide clarity on what constitutes "management" for the purposes of the exemption. The EU caselaw on the issue is unclear, with a recent judgment generating concerns that the scope of the term may be far

narrower than previously thought. We would recommend a clear definition of the term, based, broadly, on a simplified version of what the industry has (until recently at least) thought to be its scope.

- Between 2014 and 2017 an unprecedented amount of new tax legislation was introduced that has resulted in a complete overhaul of how investment managers are taxed on their returns. Certain of these rules were made hastily with little effective consultation as to their consequences and it is probably fair to say that many managers, as well as HMRC, have taken time to get to grips with them all. Although in terms of measures relating to the returns of investment managers, the period since then has been a period of relative calm, managers have still had many other changes to the UK tax code to contend with (e.g. the complex regime extending gains tax for non-residents on disposals of UK land and the upcoming introduction of "DAC 6" reporting (see below)) as well as the Brexit uncertainty that looks set to continue until at least the end of the year. Accordingly, whilst being cognisant of the current fiscal pressures on the UK economy as a whole, the introduction of any further rules specifically targeting the investment management industry that are not aimed at simplifying the current position or making the regime more internationally competitive 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. We therefore recommend that no further changes are made for at least 5 years that specifically target the tax treatment of investment managers' returns and which would be expected to have a negative impact on them.
- 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 last few years has been the OECD's project on base erosion and profit shifting ("BEPS") and this influence is likely to continue for the foreseeable future. It is hard to understate the size of the changes that have already been introduced in the UK relating to BEPS implementation. In the context of investment funds, the most significant BEPS-related UK tax changes have, for many fund managers, been the introduction of the UK's hybrids code and corporate interest restriction regime, and it will be important that the Government learns lessons from these. In both cases the UK was an "early adopter" of the recommendations and hurriedly introduced highly complex regimes. This meant that there were flaws and shortcomings in the legislation (which have required various amendments to be made and form the basis of the hybrids consultation in the Fund Review), a lack of definitive and clear HMRC guidance at the outset of the regimes and taxpayers were generally underprepared to implement them. Anti-avoidance policy generally has greatly exacerbated unpredictability in the development and application of tax policy in recent years. The manner in which highly complex anti-avoidance legislation (including, in relation to the taxation of fund managers' returns (see above)) is introduced has been problematic, with many changes being made piecemeal and without sufficient notice or consultation. We therefore strongly recommend that the direction of tax policy be stable and clear, and rule changes subject to proper consultation and debate.
- The next BEPS recommendation that is due to impact on asset managers is Action 12 (the introduction of mandatory disclosure rules), which the UK has introduced by enacting into UK law a wide-ranging disclosure regime based on the European Union directive implementing that action ("DAC 6"). Disclosures will need to be made in early 2021 but the regime's impact on the fund management industry is currently unclear. We therefore recommend that HMRC provides further guidance on the regime that is specific to the asset management sector.
- The most significant BEPS changes on the horizon will probably be those relating to Action 1 (tax challenges arising from digitalisation). The OECD is currently working on two proposals that will potentially have huge consequences for international taxation. Broadly, "Pillar One" seeks to introduce a new taxing right for countries in relation to non-residents who do not have a physical presence or permanent establishment in their jurisdiction and "Pillar Two" seeks to introduce a global minimum tax rate. Two key issues for the asset management sector come out of this:
  - First, that the UK, as an important fund management centre, supports that industry at the country level discussions relating to the scope of the new rules. In particular, Pillar One is aimed at "consumer" facing businesses and, therefore, companies and businesses which fall within this category and are owned by funds will be within its scope. However, because alternative investment funds and their managers

are not consumer facing, it is hoped and expected they will not be within scope and that the UK Government will support this position. In addition, the asset management sector will want Pillar Two not to cut across national regimes designed to ensure that fund structures are tax neutral.

– Second, it will be important for the UK's competitiveness that the UK stays in step with other developed economies both in the timing of implementing new rules and their scope, and that, if and when any such implementation occurs, HMRC provides extensive guidance and support to taxpayers.

WHAT WE CAN DO

While no one, whatever side of the debate you were on, has welcomed the last four years of uncertainty, a consequence has been that the alternatives asset management industry as a whole has generally prepared for the worst. As a result, the industry is actually in a good position to grow from this point – it has ensured that it can continue to access its required capital and investments and now it is in a position to grow its UK presence should our legal and regulatory regime encourage it to do so.

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 to all stakeholders in the sector and the wider economy.

That said, change has to be sustainable. It must be clear, readily comprehensible, competitive and flexible. It must offer long-term certainty, as change bears a cost.

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

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.

Our views set out in this summary are based on the political and economic position at the end of August 2020. 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 look forward to negotiating those challenges and opportunities with you.

ABOUT TRAVERS SMITH

WE ARE A FULL SERVICE LAW FIRM WITH 87 PARTNERS AND OVER 300 LAWYERS BASED IN THE CITY OF LONDON

The world of investment funds is fast paced, sophisticated and dynamic.

By aligning ourselves with your ambitions, we act as a one-stop shop for global and domestic asset managers to help you navigate the ever-evolving landscape and reach your goals.

With a wealth of knowledge built through years of experience, and an award-winning team of dedicated experts, we find efficient, commercially-minded solutions. We advise funds and their managers on all aspects of their business, from structuring and formation to close and implementation of their investment strategy.

Advising fund managers, executives and investors on both transactional and advisory work across all fund structures equips us with a unique insight into the market and the trends shaping it. We share this insight and tailor our advice to drive for your best terms and keep you on top of the market.

INTEGRATED TEAM STRUCTURE

A Travers Smith team consists of partners, associates and trainee and paralegal support to ensure your work is done at the right level to help improve cost efficiencies.

Where advice is required from a multi-disciplinary team, we will coordinate and project manage all advice that is needed for your matters, ensuring a seamless single team approach.

DIVERSITY & INCLUSION, CSR AND SUSTAINABILITY

DIVERSITY & INCLUSION

Our approach to diversity and creating an inclusive workplace goes beyond just ticking a box. We want everyone to be themselves at Travers Smith. We value everything that makes us unique and we recognise that celebrating our differences helps make the firm a special place to work. Read more about our diversity and inclusion initiatives.

CSR

From working with emerging artists to supporting refugees and asylum seekers, our award-winning CSR Programme is diverse, exciting and ever expanding. Our programme covers an unusually broad range of areas and touches the lives of many thousands of people from all over the country and beyond. Read more about our CSR initiatives and discover more information on our pro bono activities.

SUSTAINABILITY

Environmental issues are one of the biggest challenges facing the modern world. As a leading business, we want to do our bit to drive change. To create real change, we recognise that everyone needs to do their part and we are committed to doing ours. Read our full Environmental Policy to find out more about our environmental activities and achievements to date.

For further information please get in touch with your usual Travers Smith contact

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