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BREXIT

The jury is out on jurisdictions

Luxembourg is winning favour as a fund jurisdiction, but the UK still holds plenty of attractions for investors, say Sam Kay and Emily Clark of Travers Smith

It is now over 1,000 days and counting since the United Kingdom voted to leave the European Union. At the time of writing, as we sail past the original 29 March exit date, there remains a lack of clarity over when, how and even if Brexit will be implemented. As the UK is the largest centre for asset management outside of the US, with the Investment Association calculating in its 2018 survey that UK-based firms manage 35 percent of assets under management in Europe, this situation creates challenges and confusion for those of us who operate in the European asset management industry.

Kay: expect further creative solutions

Despite this backdrop of Brexit uncertainty for the funds industry, we have seen a strong market for European private capital fundraising over the last couple of years. Although the markets were a little more circumspect towards the end of 2018, the longer-term trend has been very positive and the signs are that 2019 will also be healthy for fundraising activity.

Applying the old maxim of "If it ain't broke, don't fix it", one may expect that asset managers are trying to make as few changes as possible when approaching their next fund. However, the evidence points to a clear shift in where funds are being structured and domiciled.

In 2015, nearly half of all European-focused private capital funds were structured in either the UK, Jersey or Guernsey; by 2018, recent data from Preqin shows that this has fallen to just under one-third, whereas Luxembourg had jumped to 28 percent to become the most favoured jurisdiction for setting up new funds.

The numbers are more marked when one drills down to analyse what UK-based fund managers have done. The same published data shows that in 2015 over three-quarters of funds for UK-based managers were domiciled in the UK or the Channel Islands (45 percent and 32 percent, respectively) and only 9 percent in Luxembourg. By 2018, the number of funds set up in the UK had dropped to 41 percent and in the Channel Islands had dropped more significantly to 21 percent, while Luxembourg had leap-frogged the Channel Islands with 23 percent of all funds established by UK-based managers domiciled there. Although it is easy to read too much into statistics, that looks like a meaningful change and coincides with the period of Brexit uncertainty.

It is possible to argue that there are other factors at play here. Running a close second to 'Brexit' in the buzzword bingo stakes is 'substance', driven by the implementation of the Organisation for Economic Co-operation and Development's drive against Base Erosion and Profit Shifting (or BEPS).

Many asset managers are looking at their fund domicile through the lens of building up substance for all the economic activity that may be undertaken in a particular jurisdiction. Also, the increase in the number of private debt funds should not be ignored; for various tax and regulatory reasons, Luxembourg and Ireland are often preferred jurisdictions to the UK or the Channel Islands for private debt fund structures. However, Brexit considerations are clearly a strong contributing factor to changes in fund domicile.

Given this backdrop, what are the current options and issues for a private fund manager when deciding where to locate its next fund?

OPTION 1 – THE UK

The traditional UK limited partnership is still an attractive structure for investors. It is familiar to investors, having the same legal form and the same heritage as the vehicle used in other jurisdictions (such as Delaware, the Cayman Islands and the Channel Islands); the limited partnership provides limited liability for investors; it is flexible, so the terms can be adapted to reflect the commercial requirements; and recent reforms in the UK have made helpful updates, for example the private fund limited partnership (or PFLP) regime sets out a 'white list' of activities that will not constitute limited partners taking part in management. The UK also benefits from a sophisticated and trusted regulatory regime.

With the limited partnership's transparency for taxation of income and gains, and the ability to prevent VAT arising on management fees (by structuring arrangements so as to include the UK fund management vehicle in a VAT group with the fund itself, through its general partner), the overall message is that the UK is still very much a "good" place from a tax perspective in which to locate a fund.

However, increasing effort is now required to ensure tax efficiency. For example, the UK has sought to counter perceived tax avoidance by restricting the circumstances in which managers are able to treat their carried interest as a capital gain (and so subject to lower rates of tax than income profits). Although capital treatment should still be available to managers in a fund with a traditional carried interest structure, the rules are complicated to apply and require on-going monitoring of the fund's activities by the fund manager.

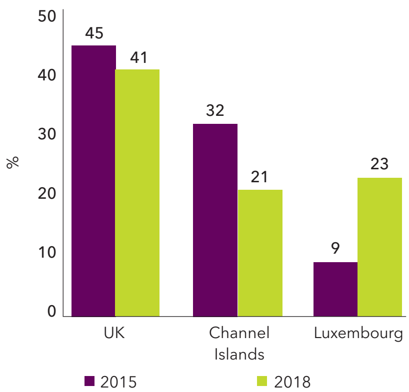
The current primary issue for the UK, though, is simply one of perception. Because of Brexit, do investors want exposure to UK structures? Do asset managers want to give the impression of having a more pan-European business? What do investment professionals think about living and working in the UK?

From a more technical perspective, Brexit is also creating uncertainty around how a private fund managed from or located in the UK may be marketed on a pan-European basis. Absent any other arrangement being put in place (and there were no indications in the Brexit Withdrawal Agreement or Political Declaration that any alternative arrangements would be countenanced), once the UK leaves the EU it will be treated as a 'third country' for marketing purposes under the AIFM Directive. Funds domiciled in the UK will, therefore, lose the ability to acquire pan-European marketing passports.

Although UK asset managers should be able to make use of national private placement regimes (NPPRs) in many investor jurisdictions and possibly transitional relief in others, in the event of a cliff-edge 'hard Brexit' there is the short-term risk of dislocation, which could lead to brief marketing blackouts. UK managers will also need to consider local licensing requirements in relation to business development and investor relations professionals on a fact-specific, case-by-case basis.

THE LURE OF LUXEMBOURG

Domicile choices of UK-based fund managers (2015 vs. 2018)



Source: Preqin

OPTION 2 – THE CHANNEL ISLANDS

Similar to the UK, the Channel Islands (Jersey and Guernsey) have attractive limited partnership vehicles available and a long history of structuring private funds. Further, for over five years the Channel Islands have been successfully navigating NPPR requirements when marketing funds across the EEA and all the required co-operation agreements are in place, so there will be no direct marketing impact as a result of Brexit. The islands also have a strong network of experienced service providers and other professionals who have a positive and collaborative relationship with their respective local regulators.

> *The evidence points to a clear shift in where funds are being structured and domiciled*

From a tax perspective, a Channel Islands limited partnership still offers tax efficiency, being transparent for the purposes of the taxation of income and gains and outside the scope of VAT. This latter point is still an advantage over the UK limited partnership, as it should allow a UK fund manager to recover the input VAT it pays on supplies it receives which are attributable to its own supply of fund management services to the fund (whereas the grouping route referred to above in the context of UK limited partnerships typically significantly limits input VAT recovery by UK fund managers).

All that being said, as an alternative to the UK, the attractiveness of the Channel Islands for many funds (and investors) is being challenged by the rise of Luxembourg. As well as a perception problem, there is also an indirect Brexit impact. Whereas previously a firm may have set up as an authorised and regulated investment adviser in the UK and then provided investment advice to a Jersey or Guernsey based GP, because of substance and other requirements that firm may now establish an investment management presence in Luxembourg or another European jurisdiction (such as Ireland) with the knock-on consequence that the domicile of the fund will follow where the investment manager has been located.

In addition, in recent times, as low tax jurisdictions, the Channel Islands have had a perception problem, with »

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THE PROS AND CONS

Luxembourg

✓ Improved limited partnership structure
✓ New RAIFs are 'game-changer'
✓ Well-established as leading EU jurisdiction
✗ Additional substance requirements
✗ Signs of overheating as popularity grows

The Channel Islands

✓ Attractive LP vehicles available
✓ Long history of structuring private funds
✓ Outside the scope of VAT
✗ Tax avoidance perception problem
✗ EU investment management presence required

UK

✓ Familiar to investors
✓ Flexible terms
✓ Sophisticated legal and regulatory regime
✗ Short-term risk of dislocation
✗ Loss of EU marketing passports
✗ Increased tax efficiency effort required

> **The uncertainty created by Brexit, particularly in the UK, has the potential to derail the positive fundraising environment that currently exists in Europe**

» certain investors being concerned that investment in funds based there would be perceived as involving tax avoidance. In response, the Channel Islands will point to the increased "substance" requirements that they have recently introduced and the fact that, in March, they were removed from the EU's "grey list" (broadly, a list of jurisdictions which were required to make changes to their tax rules to avoid being blacklisted). However, the Netherlands' recent inclusion of them on its own blacklist must be set against that progress.

OPTION 3 – LUXEMBOURG

Luxembourg's development of its limited partnership structure in recent years, including the introduction of the common limited partnership (société en commandite simple, or SCS) and the special limited partnership (société en commandite spéciale, or SCSp), has given it an attractive model with similar benefits to a traditional Anglo-Saxon limited partnership: contractual flexibility, protecting the limited liability of investors, a quick establishment process, and, generally, transparency for the purposes of the taxation of income and gains.

However, the real game-changer for the private funds market was the introduction of the 'reserved alternative investment fund' or RAIF. Previously, the regulatory framework in Luxembourg tended to require the fund itself to be regulated (a process that was often more cumbersome, time-consuming and costly than options in other jurisdictions). But, with the introduction of the AIFM Directive, the RAIF was introduced, which allowed the Luxembourg regulator (the CSSF) to supervise the fund indirectly through the RAIF's alterative investment fund manager. As a model, this closely resembles the approach taken in the UK and the Channel Islands (and in other jurisdictions like the United States).

The RAIF still requires an 'alternative investment fund manager' and, to access all the marketing benefits under the AIFM Directive (eg, the pan-European marketing passport), this manager will need to be regulated by the CSSF. Building out a new regulated entity within a wider group structure is not something that a business will undertake lightly. It is also worth noting the circular issued by the CSSF in August 2018 sets out some detailed substance requirements for any Luxembourg-based alternative investment manager, including on governance, the responsibilities of senior management, delegation and staffing requirements. But there are two variations to be considered:

1. Rather than the asset management firm having its own regulated business, it may engage a third-party platform to act as the regulated AIFM for the fund. The asset manager (through the GP that it sets up) still has responsibility for and oversight over the management of the fund, but the third-party AIFM fulfils the regulatory functions required by the AFIM Directive. There are an increasing number of reputable AIFMs offering this service and it is becoming more accepted within the wider funds market.
2. The CSSF permits delegation of investment management/portfolio management and/or risk management activities to regulated businesses in other jurisdictions. It is, therefore, possible that the private fund may be domiciled in Luxembourg (eg, using its limited partnership structure) but the fund management is undertaken elsewhere. This could include a UK entity acting as the AIFM. Legislation submitted in Luxembourg earlier this year allows for UK AIFMs to continue to manage Luxembourg-domiciled

alternative investment funds for a maximum period of 21 months from the official date of a hard Brexit (only in relation to existing contractual relationships at the time of a hard Brexit). The uncertainty around what happens after this transitional period may prevent this being a long term solution.

In addition, Luxembourg is well established as a leading European jurisdiction in which to locate holding companies. A result of the BEPS project has been to place increasing emphasis on companies to show that they are carrying out genuine activities in a jurisdiction before claiming tax benefits that come from residence in that jurisdiction. This emphasis on "substance" in a jurisdiction is increasingly leading to fund management firms scaling up their presence there. A side effect of greater resource of being located in Luxembourg (to support the residency of holding (and other) companies located there) is that the fund managers are increasingly prepared to locate the fund itself in Luxembourg. However, a point to watch is that Luxembourg has recently implemented many of the requirements of the European anti-tax avoidance directive and will implement the remainder in due course. It is, as yet, unclear the extent to which this and recent case law developments from the Court of Justice of the European Union relating to substance will impact on Luxembourg's attractiveness.

Of course, in the event of a hard Brexit, the EU27 marketing passport will not facilitate marketing by a Luxembourg AIFM to UK institutional investors. So, a UK NPPR registration may be required. Also, the local licencing requirements for business development and investor relations professionals who are not physically based in Luxembourg or another EU27 country will also be relevant to this model on a fact-specific, case-by-case basis.

***Clark**: Ireland is one to watch*

Given the recent increase in the use of Luxembourg as a domicile for private fund strategies, there are some signs of overheating, such as increased costs, difficulties in securing suitable personnel to meet the substance requirements and processes taking longer to finalise. There have also been questions over whether all the same concepts apply in comparison to common law jurisdictions. But, given the flexibility with the structure and positive tax and regulatory framework, we would expect Luxembourg to continue to be attractive as a fund domicile for some time to come.

LEARNING TO ADJUST

The uncertainty created by Brexit, particularly in the UK, has the potential to derail the positive fundraising environment that currently exists in Europe. By the time this article is published, the UK may have crashed out of the EU, or the uncertainty may be prolonged for further weeks, months or years.

However, despite these challenges, the asset management industry is adjusting and one way it is doing so is by undertaking additional analysis on private fund structures and domiciles. As highlighted by the discussion above, this is making the art of fund structuring more complicated with a matrix of issues to be considered (for example different regulatory frameworks, tax considerations, past practice, future growth plans).

Clearly, Luxembourg is an attractive option for more and more asset managers. But, based on the statistics set out above, in 2018 over 60 percent of all UK-based managers made use of the UK or the Channel Islands for their fund domicile. Given the strength of the UK asset management industry, that is a significant proportion of the market.

It is also worth noting that, although the UK, the Channel Islands and Luxembourg are the most common options, they do not hold a monopoly on fund domiciles. Some European-focused funds, particularly for US managers, may be located in Delaware or the Cayman Islands, while other funds may be established in the same jurisdiction as the fund manager (e.g. a French FCPR or a Dutch CV). One to watch is Ireland, where a legislative process is currently looking at revamping their limited partnership structures. In due course, this may provide another attractive option for European fund managers. Given the sophistication of the industry, there are likely to be further creative solutions and adjustments in the years to come when considering fund structures. ■

***Sam Kay** is head of Investment Funds at Travers Smith and specialises in fund formation work for a wide range of private funds. He has over 20 years' experience working on investment funds projects and he has been a partner at Travers Smith since 2008. He also works on secondaries transactions, carried interest arrangements and co-investment schemes.*

***Emily Clark** is a partner in the tax group at Travers Smith. She specialises in the taxation of asset managers and investment funds, acting for private equity houses, debt funds, infrastructure, venture and real estate funds. She has particular expertise in partnership taxation, VAT on fund management fees and carried interest.*