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Investment Funds 2022

UK: Law & Practice

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Law and Practice

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1. MARKET OVERVIEW

1.1 State of the Market

The UK is regarded as one of the leading global asset management centres, with an investment funds industry covering both traditional and alternative asset classes. Due to having considerable experience and infrastructure, the UK is one of the most prominent jurisdictions for fund formations, and has developed a sophisticated market, offering a range of both closed-ended and open-ended types of funds. The asset management industry is of vital importance to the UK's economy, now more than ever as the economy seeks to recover from the financial impact of the COVID-19 pandemic.

Within the UK market, alternative investment funds (AIFs) – as defined in the EU Alternative Investment Fund Managers Directive (AIFMD) and replicated in the UK's post-Brexit AIFM legislation (UK AIFM Regime) – include private closed-ended funds, often structured as English or Scottish limited partnerships, which are commonly used for funds that focus on illiquid asset strategies (eg, private equity, venture capital, real estate, alternative credit and infrastructure funds). Listed closed-ended funds available for sale to the general public are also common, and are used for both liquid and illiquid asset strategies. The vehicles most often used are investment trusts (ITCs) and, in the case of funds that intend to invest in real estate, real estate investment trusts (REITs).

Retail funds tend to be open-ended vehicles, which can be – from a regulatory perspective – either an undertaking for collective investment in transferable securities (UCITS) fund or a non-UCITS retail scheme (NURS). One of the key advantages of a UCITS fund is that it can be marketed to investors throughout the EU without the need for additional, local authorisation in each country, known as the UCITS marketing passport. A NURS provides a similar level of investor protection to that of a UCITS and allows the manager more flexibility in terms of the investments the fund can make, but does not benefit from the UCITS marketing passport. In addition to the UCITS and NURS, there is also a more lightly regulated regime for institutional and certain other qualified investors: the qualified investor scheme (QIS).

The UK provides for a large number of open-ended vehicles that fall within these two categories, including authorised unit trusts (AUTs), open-ended investment companies (OEICs) and authorised contractual schemes (ACSs). Different authorisations apply, depending upon the investments to be made. For example, OEICs that invest in real estate may be structured as property authorised investment funds (PAIFs), provided the relevant conditions are met, and OEICs that invest in unauthorised funds need to be authorised as funds of alternative investment funds (FAIFs).

The UK's exit from the EU has brought about a number of changes to the way in which funds will be managed and marketed in the UK, as explained in this chapter. It has, however, also created an opportunity to look at the regulation and tax framework of the UK asset management and funds industry in order to create a legal, regulatory and tax regime that remains attractive to fund managers, advisers and infrastructure.

2. ALTERNATIVE INVESTMENT FUNDS

2.1 Fund Formation

2.1.1 Fund Structures

Private Funds

The typical structure of a UK private equity or venture capital fund is most commonly an English limited partnership, which is a form of partnership governed by the Limited Partnerships Act 1907 (LP Act 1907). Under the LP Act 1907, English limited partnerships must have at least one general partner (GP), who is responsible for the management of the limited partnership, and one or more limited partners. Thus, investors in such funds are limited partners in the partnership. One of the fundamental attractions in the UK of a limited partnership structure for private closed-ended funds is that the limited partnership is a flexible vehicle in terms of internal governance and control.

In recognition of the importance of the private closed-ended funds business to the UK finance sector, the government introduced important reforms to the UK limited partnership law applicable to private funds, which took effect in 2017. The reforms introduced the concept of a "private fund limited partnership" (PFLP) – an English limited partnership with certain modifications, so as to simplify the regime, making it a more attractive and competitive choice of vehicle. Most private equity and venture capital funds (and related vehicles, such as co-investment vehicles and feeder funds) will fulfil the relevant PFLP conditions and can therefore choose to be designated as a PFLP (although it is not mandatory to do so).

It is also possible for a private closed-ended fund in the UK to be structured as a unit trust scheme. The English law concept of a trust has no equivalent in some other jurisdictions. It is a structure under which title to the fund's assets is held by a person with legal personality (the trustee) for the benefit of the fund's investors (the beneficiaries). The document constituting the trust (the trust deed) governs the relationship between the trustee and the beneficiaries, and strict fiduciary duties are owed by the trustee as a matter of law. A trust does not have a separate legal personality; all legal relationships are entered into by or on behalf of the trustee. These vehicles have historically most commonly been used for certain UK real estate fund structures.

In November 2021, rules came into effect for a new UK fund structure: the Long-Term Assets Fund (LTAF). The LTAF is a UK-authorised fund that is designed to be focused on long-term, illiquid assets and is particularly targeted at increasing defined contribution pension scheme investment into alternative assets.

The LTAF is an authorised fund so can be structured as an open-ended investment company (ICVC), unit trust or contractual scheme. There is an increasing expectation that the LTAF will play a significant role in attracting long-term capital to the market (for further details on the LTAF, see **4.1 Recent Developments and Proposals for Reform**).

It would also be common for a UK-based private fund manager to establish its private closed-ended fund as an offshore vehicle (whether a partnership, a unit trust or a corporate entity). However, for the purposes of the description of closed-ended private funds in this chapter, the focus will be on English limited partnerships.

Listed Funds

The vehicles used most often are ITCs and REITs. These are typically structured as public limited companies under UK companies legislation and listed on a recognised stock exchange, most commonly the Premium Segment or the Specialist Funds Segment of the Main Market of the London Stock Exchange, although other stock exchanges both in and outside of the UK recognised by Her Majesty's Revenue & Customs (HMRC) are possible. As public limited companies, ITCs and REITs will have a board of directors who are responsible for managing their affairs. The board of directors will typically delegate the day-to-day operation of the investment trust. For example, investment management functions are usually delegated to a fund management company, a depositary/custodian will be appointed to be responsible for the safekeeping of the company's assets, a registrar will be responsible for the share register, and a broker will advise on the listing of the company's shares. The fund manager, depositary/custodian and broker will usually be authorised and regulated by the Financial Conduct Authority (FCA).

2.1.2 Common Process for Setting Up Investment Funds

Private Funds

The statutory framework in the UK requires an English limited partnership to be registered as such. This entails providing an application for registration to the (public) Registrar for Limited Partnerships (held at Companies House), providing certain details including the name of each limited partner and the amount of capital contributed by each limited partner. This will be conclusive evidence that an English limited partnership came into existence on the date of registration. Any changes to these details during the continuance of the English limited partnership must be similarly registered within seven days of the relevant change.

The key document for private closed-ended funds is the limited partnership agreement; this is a freely negotiated contract, with very few provisions prescribed by law, and is not available publicly. All parties will heavily negotiate the agreement prior to its execution. Other frequently used key fund documentation includes side letters (providing certain investors with specific terms required for their specific circumstances), the subscription agreement for investors to subscribe for a commitment and be admitted as a partner in the limited partnership, and the investment management agreement for the fund to appoint the manager.

Listed Funds

An ITC is typically a UK public limited company that has been approved by HMRC as an ITC for the purposes of the relevant tax legislation. ITCs are subject to special tax rules (discussed below). Similarly, a REIT is typically a UK public limited company that has been approved by HMRC as a REIT for the purposes of the relevant tax legislation. REITs are also subject to special tax rules (discussed below).

A key consideration when setting up an ITC or REIT is that the eligibility conditions (and, post-launch, the ongoing requirements) set out in the relevant tax legislation need to be met in order to gain the tax advantages enjoyed by such vehicles. Tax lawyers should be engaged early in the process to provide advice on the steps necessary for a company to meet these requirements. Offers in respect of ITCs and REITs are subject to the obligation to publish a prospectus under the domestic legislation deriving from the EU Prospectus Regulation. Where a prospectus is required, this will need to be approved in an EEA Member State for use in the EEA, in addition to being approved by the FCA for use in the UK. The other key document produced will be the investment management agreement for the fund to appoint the manager.

2.1.3 Limited Liability

Private Funds

The liability of a general partner for the debts and obligations of a partnership is unlimited, whereas the liability of the limited partner is limited to the amount of capital it contributes to that partnership. Also, unless the partnership is a PFLP, there is a restriction on the ability of limited partners to withdraw capital during the life of the partnership. To keep the capital element as small as possible, limited partners will typically split their commitments into a loan element (typically 99.99% of total commitments) and a capital contribution element (typically 0.01% of total commitments).

Listed Funds

In respect of ITCs and REITs, under UK companies legislation the liability of the shareholders for company debts is limited to the capital originally invested in the fund.

2.1.4 Disclosure Requirements

Private Funds

Although not required by UK law, the key marketing document that is usually used for a closed-ended private fund is a private placement memorandum (PPM). UK law generally requires that any marketing material, including a PPM, is “clear, fair and not misleading”. Depending on the intended recipient, the PPM may also need to be approved by an FCA-authorised person. Under the UK AIFM Regime, there are also specific requirements to make set disclosures to investors prior to their investment into the fund. These disclosures are usually included in the PPM.

Listed Funds

In addition to the UK AIFM Regime disclosure requirements, ITCs and REITs must also comply with the disclosure requirements set out in the FCA’s listing, prospectus, disclosure guidance and transparency rules.

Under UK companies legislation and the FCA’s listing, disclosure guidance and transparency rules, UK incorporated ITCs must also publish annual and semi-annual reports and accounts. The annual report and accounts must be prepared in accordance with applicable accounting standards and must give a true and fair view of the assets, liabilities, financial position and profit and loss of the company. The semi-annual financial reports do not need to be audited, but it is common practice to ask the auditor to cast an eye over them, and the audit committee of the fund should certainly review them.

Under the UK’s Packaged Retail and Insurance Based Products (PRIIPs) Regime, derived from the EU PRIIPs Regulation, a short, standardised disclosure document containing the key information about the product being offered – a key information document (KID) – must also be produced and published for investment products marketed to retail investors in the UK. If an investment product will also be marketed to retail investors in the EU, a separate KID prepared in accordance with the EU PRIIPs Regulation must also be produced and published. The UK PRIIPs Regime is currently operationally equivalent to the EU PRIIPs Regulation, although some divergence between the two regimes is expected to occur (see **4.1 Recent Developments and Proposals for Reform**).

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Private Funds

Investors typically seen investing in private closed-ended funds in the current market include pension funds, sovereign wealth funds, endowments, insurance companies, fund of funds and high net worth individuals.

Listed Funds

Closed-ended listed funds can be marketed broadly and attract both institutional and individual investors.

2.2.2 Legal Structures Used by Fund Managers

Private Funds

Limited liability partnerships (LLPs) tend be the most commonly used legal entity for the management entities of private equity and venture capital funds, who are attracted by some of the benefits of the LLP structure, such as flexibility, and the fact they are transparent for direct tax purposes and benefit from national insurance contribution savings.

Listed Funds
The legal structure used for the management entity of listed alternative funds will depend upon the jurisdiction in which the manager is based. The most common structure seen is a corporate vehicle.

2.2.3 Restrictions on Investors
Other than general marketing/financial promotion rules in the UK, there are no restrictions under UK legislation on the type of parties which can invest in a fund. However, in practice, REITs seek to prevent corporate investors from holding interests of 10% or more due to the adverse tax consequences that would otherwise arise.

2.3 Regulatory Environment

2.3.1 Regulatory Regime
A closed-ended fund in the UK will almost certainly be an AIF for the purposes of the AIFMD and for the purposes of the UK AIFM Regime, which defines an AIF as any investment fund that is not subject to the UK UCITS regime. As such, the AIF's manager will be an alternative investment fund manager (AIFM) for the purposes of both regimes and will need to be authorised to carry out AIF management in respect of that vehicle. Any person who carries on the activity of managing an AIF in the UK without being duly authorised, and in the absence of an exclusion, commits an offence. In addition, if he or she has entered into an agreement with another person (eg, an investor) in the course of that activity, this agreement is unenforceable against that other party, who is entitled to receive his or her money back, and to compensation for any loss.

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

2.3.2 Requirements for Non-local Service Providers
The AIFMD sets out various provisions relating to service providers, such as depositaries and valuers. UK legislation does not restrict the use of non-UK service providers to provide these services.

However, one restriction does apply in the UK in respect of external valuers: UK legislation prohibits an external valuer from delegating valuation to a third party.

Under the AIFMD, the depositary of an EEA AIF must be established in the home Member State of that AIF. Therefore, post-Brexit EU AIFs are no longer able to use UK banks as depositories, and UK AIFs are no longer able to use EU banks as depositaries.

2.3.3 Local Regulatory Requirements for Non-local Managers
EEA AIFMs are no longer able to exercise management passport rights available under the AIFMD. Authorisation will be required from the FCA to manage a UK AIF. As a temporary measure, EEA AIFMs were able to seek authorisation in the UK to use the FCA's temporary permissions regime (TPR) to continue to access the UK market but the deadline by which firms and fund managers had to notify the FCA that they want to use the TPR has now passed.

Generally, a fund delegates investment management, and it is usual to see delegation to either an FCA-regulated investment management firm or an investment manager domiciled outside of the UK. Any firm applying for authorisation or registration by the FCA must have its head office in the UK. Although the FCA will judge each application on a case-by-case basis, the key issue in identifying the head office of a firm is the location of its central management and control.

The AIFMD permits the delegation of portfolio management activities by an EEA AIFM to non-EU managers, subject to a number of strict conditions. As the UK is now a third country for these purposes, delegation or sub-adviser arrangements between an EEA AIFM and UK managers may need to be updated to satisfy those requirements. AIFMs may also need regulatory approval for the delegation.

2.3.4 Regulatory Approval Process

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

- authorisation under the Financial Services and Markets Act (FSMA) as a full-scope UK AIFM;
- authorisation under the FSMA as a small authorised UK AIFM; and
- registration as a small registered UK AIFM.

The type of licence that is applicable to the manager will depend on the total amount of assets it has under management and the nature of the AIFs managed.

2.3.5 Rules Concerning Marketing of Alternative Funds

The activity of marketing or promoting securities or other investments is not in itself a regulated activity requiring any form of licence in the UK. However, there are circumstances where someone whose main aim is to make promotions either for their own purposes or on behalf of others (or to help others to make promotions) may, in conjunction with the marketing or promotion, be engaged in regulated activities. In this regard, the most likely regulated activities under the Regulated Activities Order are those of “arranging deals in investments” or “advising on investments”. A firm will require authorisation, with specific permission for the relevant activity, to the extent that it is deemed to carry on such activities in the UK.

2.3.6 Marketing of Alternative Funds

In practice, marketing activities in relation to a fund will also often involve the regulated activities of making arrangements with a view to another person buying or subscribing for interests in the fund. In view of this, fund marketing activities in the UK are generally conducted only by authorised persons. Any person conducting marketing activities in relation to a fund should consider whether authorisation is required and, if it is authorised, whether it has the appropriate permissions from the FCA to undertake these activities.

The promotion of an interest in an unregulated collective investment scheme (such as a limited partnership interest) is restricted in the UK. It cannot be promoted to the general public and, even for a private placement, there are broad restrictions on its promotion to different categories of recipients. The persons to which a limited partnership interest can be promoted include:

- investment professional organisations;
- high net worth organisations; and
- in limited circumstances, some certified high net worth individuals and sophisticated individuals.

In the UK, the FCA permits the marketing of a private fund to a wider group of recipients than the category of “professional investors” referred to in the AIFMD, provided the financial promotion rules referred to above are complied with throughout the entire marketing process.

Since 1 January 2021, full-scope UK and EEA AIFMs are no longer able to use the AIFMD marketing passport to market into the UK and will need to rely on the UK national private placement regime instead. This will only be possible if the UK and the EU Member State in question have entered into a regulatory co-operation agreement. As a temporary measure, pursuant to the FCA's temporary transitional powers, UK AIFMs can continue to market an EEA AIF, and EEA AIFMs can continue to market an AIF, in the UK as they had before 1 January 2021, until 31 March 2022.

The UK did not adopt the pre-marketing rules contained in the EU cross-border distribution of investment funds legislation, which came into force in EU Member States in 2021. Such rules may, however, be adopted by individual EU Member States in their national private placement regimes in due course, impacting the ability to market into those jurisdictions.

2.3.7 Investor Protection Rules

The two main investor categories in relation to the distribution of funds in the UK are "professional investors" and "retail investors". A "professional investor" is one who is considered to be a "professional client" (ie, a "per se professional client" or an "elective professional client", in each case within the meaning of MiFID).

An investor will be a "per se professional client" if it fulfils one of a number of objective criteria listed in MiFID. The list includes regulated financial entities, large undertakings, governments and public bodies, and investors whose main activity is to invest in financial instruments.

Any investor that does not satisfy any of the "per se" criteria in MiFID will be categorised as a "retail client", unless it can be treated as an "elective professional client". To be able to do this, the manager must assess the expertise, experience and knowledge of the investor and whether this makes him or her capable of making his or her own investment decisions and understanding the risks involved (the "qualitative test"). The investor must further pass the "quantitative test", meaning that they have satisfied two out of the three following requirements:

- having carried out transactions of a significant size on the relevant market at an average frequency of ten per quarter over the previous four quarters;
- having a financial instrument portfolio exceeding EUR500,000; and
- working or having worked in the financial sector for at least one year in a professional position.

An investor satisfying the relevant qualitative and quantitative tests and wishing to opt-up must be given a clear written warning of the protections and investor compensation rights he or she may lose, and he or she must state in writing that he or she is aware of the consequences of losing these protections and wishes to be treated as a "professional client".

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

2.3.8 Approach of the Regulator

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

2.4 Operational Requirements

An FCA-authorised manager must comply with the applicable FCA rules, which have been supplemented by the requirements of the UK AIFM

Regime. A key requirement is that the manager must maintain a minimum amount of capital. The amount of capital is likely to be greater if the manager operates under the UK AIFM Regime or the EU MiFID. Other requirements applicable to the typical manager in this structure include:

- prudential requirements, including relating to its governance, the remuneration of key staff, and internal systems and controls;
- FCA approvals of personnel in key positions;
- requirements relating to the conduct of the manager's business, including relating to disclosures to investors and the regulator; and
- anti-money laundering checks, including due diligence checks on new investors.

Historically, although the FCA-authorised manager has had to comply with the rules set out above, there have been few operational requirements imposed on the fund itself. To the extent that the UK AIFM Regime applies, the manager must now ensure that certain requirements are imposed on the fund, such as:

- the appointment of a depositary to have custody of certain assets and/or verify title to privately held assets;
- organisational controls (relating to risk management, compliance and valuation, for example) and conduct of business rules (relating to due diligence, execution of orders and reporting, for example) must be adhered to; and
- rules relating to companies in which the fund has a substantial stake must be complied with.

2.5 Fund Finance

The fund finance market in the UK is sophisticated and well developed, particularly for closed-ended private funds. The market includes a range of lenders, from banks to specialist debt funds, who offer finance solutions to funds and their GPs/managers. The most common product is a capital call facility, allowing the fund to draw money from the lender in anticipation of making a capital call from the fund's investors. The main advantage of this type of facility is that it will allow quick and efficient access to capital.

The fund documents (eg, the limited partnership agreement) will normally require at least ten business days' notice to be given to the investors prior to the date of any capital call, whereas the lender under a capital call facility will allow the money to be drawn on shorter notice. This type of arrangement therefore gives the GP/manager greater certainty of funding, particularly when the fund needs capital for investment purposes. It also allows the GP/manager to smooth out when capital calls are made to investors because the fund is able to make use of the facility for irregular cash requirements, such as fees and expenses.

Other types of fund finance have been developed in addition to capital call facilities, including net asset value (NAV) facilities secured on the underlying assets of the fund, fund finance arrangements to unlock liquidity for investors, and facilities targeted at GPs/managers to assist team members to participate in any "GP commitment" requirements.

Despite the developments in the market, the general principle for closed-ended private funds in the UK is that investors will not want the fund to be leveraged. This is particularly the case for a private equity fund because the investment strategy of the fund itself normally includes leveraged buyouts, so investors will not want a double layer of leverage (ie, at both the fund level and the investment level). Therefore, the limited partnership agreement in a closed-ended private fund will normally impose restrictions on the amount of leverage that may be incurred by the fund (for example, the lower of 20% of commitments made by investors and the amount of uncalled commitments), and any borrowing incurred must be on a "short-term" basis. Furthermore, under AIFMD, any fund that incurs leverage (short-term borrowing is excluded for these purposes) is subject to additional disclosure requirements, and the AIFM is required to observe a higher degree of regulation. As a consequence, it is important for common forms of fund finance (eg, capital call facilities) to adhere to both the investor-imposed and regulatory-imposed requirements.

It would be usual for the lender of a capital call facility to take some form of security. A common approach would be for the lender to have the right to require the GP/manager to drawdown from investors to pay any outstanding indebtedness under the facility. It is even possible for the lender to step into the shoes of the GP/manager and issue drawdown notices direct to the investors. For this to be possible, the lender must have the right to be assigned the right under the limited partnership agreement of the closed-ended private fund to issue these drawdown notices. This can give rise to negotiation with investors as to whether they are required to counter-sign security documents. A possible compromise is that the investor signs an acknowledgment that the right to drawdown has been assigned to the lender without the investor being a direct party to the security arrangements. An additional issue is whether the fund or investors are required to provide information to lenders. As a general rule, investors will not want to provide non-public information.

The most common issue in the UK is that investors will not want the fund to be leveraged.

2.6 Tax Regime

General

Different tax regimes apply to the different forms of UK investment fund. These are complex, and a detailed summary of them is beyond the scope of this chapter, but a high-level overview of some of the key direct tax features of common UK fund structures (at both fund and investor level) is set out here for AIFs and under **3.6 Tax Regime**. Please note that the features described are necessarily general and may not apply in certain cases – eg, depending on the assets held by the fund or the circumstances of particular investors.

As a general point, the tax structuring preference of an investor will depend on its particular identity and the asset class or classes in which the fund invests. Many funds will have a wide mix of different types of investors (eg, UK resident corporates – such as life assurance companies – and individuals, sovereign wealth funds and pension funds). Fund managers will then usually look to structure the fund so as to be tax efficient for the investor base as a whole rather than a particular investor or class of investor (unless, of course, a particular investor or class is particularly important or has been specifically targeted).

A key issue for all investors will typically be tax neutrality when investing through a fund (wherever that fund is established) – ie, they will not want that investment to leave them in a worse tax position than they would be in if they directly held the underlying assets. Investors will also commonly not want to be subject to tax filing obligations in new jurisdictions solely because of their investment in the fund, or, if that is not possible, they will commonly want to be made aware of the relevant filing obligations by the fund manager. Another factor for investors when investing in funds (wherever the funds are located) is a wish to minimise withholding taxes on their returns from the fund, due, if nothing else, to the administrative and cashflow cost.

From a UK perspective, a further important issue will be whether the fund would be considered to be trading. This can be relevant at both fund and investor level, as the tax privileges for certain UK fund types and investor classes do not extend to trading profits (eg, UK-registered pension schemes are generally exempt from tax on their investment income and capital profits but this exemption does not apply to trading profits). This can have an impact on the chosen structure.

Private Closed-Ended Funds Structured as English Limited Partnerships

Tax position of the fund and investors

As mentioned in **2.1.1 Fund Structures**, the typical structure of a UK private equity or venture capital fund is the English limited partnership. These are transparent for UK direct tax purposes, which means that each limited partner is subject to tax on the income and gains allocated to it under the limited partnership agreement (whether they are distributed or not), rather than the limited partnership itself being taxable on its income and gains.

The taxation of investors on their share of the limited partnership's income and gains depends on the nature of the underlying return that the partnership has received (eg, capital gain, interest, rent or dividend) and the investor's own tax status.

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

Listed Closed-Ended Funds – ITCs

Tax position of the fund

Companies with ITC status are subject to UK corporation tax, but (if certain conditions are met) are exempt from tax on capital gains and on profits of a capital nature from their derivative contracts and their creditor loan relationships. ITCs are also able to benefit from an elective interest streaming regime, which allows them to treat certain dividends to investors as interest distributions, enabling the ITC to claim a corporation tax deduction in respect of the interest distribution (if certain conditions are met). As a UK company, an ITC can also potentially benefit from the general UK company exemptions from tax on dividends.

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

Tax position of the investor

Investors in an ITC will be taxed on distributions (other than interest distributions) from it in the same way as for normal companies. Therefore, UK tax resident individuals will be subject to income tax, at rates of up to 38.1% (set to increase to 39.35% from 6 April 2022), and corporation tax payers can potentially benefit from the general UK company exemption from tax on dividends. Interest distributions are, broadly, treated as interest receipts, so UK resident individuals will be subject to income tax (at rates of up to 45%), and corporation tax payers will treat them as a receipt of taxable income.

Listed Closed-Ended Funds – REITs

Tax position of the fund

A REIT is tax opaque but, if certain conditions are met, benefits from an exemption from UK tax on profits and gains from its property rental business (PRB). Conditions with which a REIT must comply include that, broadly, at least 75% of its profits must come from its PRB, at least 75% of the total value of its assets must relate to its PRB, and it must distribute at least 90% of its PRB income. There is no requirement for it to distribute capital gains.

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

REITs are subject to corporation tax in the usual way on any non-PRB profits (eg, trading profits). These can be paid out as dividends, without withholding tax.

Tax position of the investor

For corporation tax and income tax payers, PIDs are generally treated as UK property income, so UK resident individuals are subject to income tax on them (at rates of up to 45%) (and credit should be given for any tax withheld on payment of the PID). Corporation tax payers will treat them as taxable income. Depending on its particular circumstances, a non-resident investor may be able to reclaim under a double tax treaty all or part of any tax withheld from PIDs paid to it.

Other distributions of profits by REITs are taxed as dividends in the normal way. Therefore, UK tax resident individuals will be subject to income tax, at rates of up to 38.1% (set to increase to 39.35% from 6 April 2022), and corporation tax payers can potentially benefit from the general UK company exemption from tax on dividends.

3. RETAIL FUNDS

3.1 Fund Formation

3.1.1 Fund Structures

An OEIC can be used for an open-ended retail fund, which is a collective investment scheme structured as a corporate vehicle. Different authorisations apply, depending upon the investments to be made. For example, OEICs that invest in real estate may be structured as PAIFs, provided the relevant conditions are met. For an open-ended structure, an AUT can also be used. This is a type of unit trust authorised by the FCA, which is constituted by a trust deed made between the trustee and the manager of the fund. The property of the AUT is legally held by the trustee but managed by the manager. The investors have beneficial ownership of the property of the fund. Many PAIFs have an AUT as a feeder vehicle to enable corporate investors wishing to hold 10% or more indirectly to invest without infringing regulatory requirements.

In 2013, two new types of tax transparent funds (ACSs) were introduced in the UK. These new types of authorised funds can take the form of a partnership or a co-ownership scheme. In practice, the co-ownership scheme has proved more popular, particularly from a tax perspective. However, ACSs are only suitable for use by institutional investors, with investment restricted either to investments of a minimum of GBP1 million or to professional institutional investors.

3.1.2 Common Process for Setting Up Investment Funds

Compared to AIFs (which fall within the scope of the UK AIFM Regime), retail funds structured as open-ended funds can be easier and cheaper to set up, notwithstanding the fact that the fund itself requires prior regulatory authorisation. Open-ended funds have their own constitutional documentation, depending upon which type of vehicle is being set up, as follows:

- a trust deed in the case of an AUT;
- an instrument of incorporation in the case of an OEIC; and
- a co-ownership or partnership deed in the case of an ACS.

In each case, the documents set out the features, powers and rules governing each authorised fund. For both UCITS and NURS funds, however structured, there are very detailed operational requirements. Day-to-day operations are detailed in the fund's prospectus.

3.1.3 Limited Liability

OEICs in the UK can be structured as a single fund or as an umbrella company with multiple sub-funds, each of which would have its own investment aims and objectives. The legal framework in the UK provides for the ring-fencing of the assets and liabilities of each sub-fund.

An AUT can have a single fund or an umbrella fund structure. In the latter case, each sub-fund is constituted under a separate trust, and the assets and liabilities of each sub-fund are ring-fenced under UK law.

3.1.4 Disclosure Requirements

Certain pre-investment disclosures must be made to investors. Under UK regulation, every manager is required to provide comprehensive information to help investors make a balanced and informed decision about any retail fund prior to investing. In most cases, this information is contained within the prospectus. Investors in open-ended funds must have access to an up-to-date prospectus at all times.

In addition, a KID must be prepared and made available to potential investors under the UCITS Directive (the UCITS KID). The UCITS KID requirements differ from those for the document that has to be produced under the PRIIPs Regulation. For example, the UCITS KID must be provided to all potential investors, not just those in the EEA; it must also be provided to both potential retail and professional investors (whereas the PRIIPs KID is only required to be made available to retail investors).

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

Open-ended funds, particularly OEICs, are popular with individual investors, insurance companies and pension funds. ACSs are increasingly popular for institutional investments and pension funds.

The new open-ended fund vehicle introduced in the UK in 2021 – the LTAF (see **2.1.1 Fund Structures**) – is primarily aimed at defined contribution pension schemes but is also available to retail clients if they are sophisticated investors or certified high net worth individuals. The FCA plans to consult in the first half of 2022 in relation to broader retail access.

3.2.2 Legal Structures Used by Fund Managers

The legal structure used for the management entity of retail funds varies and will depend upon a number of factors, such as tax considerations. The most common structure used is a corporate vehicle.

3.2.3 Restrictions on Investors

Other than general marketing/financial promotion rules in the UK, there are generally no restrictions under UK legislation on the type of parties that can invest in a retail fund. However, PAIFs cannot have a corporate investor with an interest of 10% or more (but see **3.1.1 Fund Structures** in relation to the use of feeder vehicles to address this issue).

3.3 Regulatory Environment

3.3.1 Regulatory Regime

The manager of an open-ended authorised fund must be authorised by the FCA, with permission to "manage a UCITS".

It should be noted that, since 1 January 2021, EEA UCITS funds fall within the definition of an AIF for the purposes of the UK AIFM Regime, as AIFs are defined as any investment fund that is not subject to the UK UCITS regime.

3.3.2 Requirements for Non-local Service Providers

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

The UK's authorised fund governance regime goes further than is required under the UCITS Directive in that it places a number of additional responsibilities upon depositaries and requires them to be independent (so as to avoid and manage any potential conflicts of interest).

Depositaries in the UK are also required to undertake a wide variety of oversight activities, and are subject to extensive conduct of business rules and other regulatory requirements.

3.3.3 Local Regulatory Requirements for Non-local Managers

It is possible for EEA-authorised UCITS managers to provide management services to a UK domiciled fund by exercising management passport rights available under the UCITS Directive. In order to exercise these rights, the manager must make a notification to its home state's competent authority. In the case of a NURS, it is possible for the manager to be an EEA AIFM.

As with depositaries, managers are required to be independent.

3.3.4 Regulatory Approval Process

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

3.3.5 Rules Concerning Marketing of Retail Funds

In respect of UCITS-compliant open-ended funds, the marketing of a UK retail fund can only be undertaken in EU Member States once the required documents have been filed with the FCA. The required documentation varies according to the type of fund vehicle, but is in most cases the fund's prospectus and KID. A notification letter must also be filed. The FCA then has ten working days in which to process the notification.

NURS funds fall within the UK AIFMD Regime and can therefore be marketed to the general public in the UK. NURS funds cannot be marketed to investors living in EU countries, unless the fund is approved by the regulators in each country and complies with the terms for regulated funds in each country.

Although QISs also fall within the UK AIFMD Regime, they may only be marketed to experienced investors who meet certain qualifying conditions.

3.3.6 Marketing of Retail Funds

Some open-ended funds are available for distribution to retail investors.

A "retail investor" is defined as any investor that does not meet the necessary criteria in MiFID, unless it can be treated as an "elective professional client" (see **2.3.7 Investor Protection Rules**).

In practice, many retail funds are available for purchase by the general public via investment platforms and retail supermarkets.

3.3.7 Investor Protection Rules

In the UK, there are both legal and regulatory requirements for retail funds to produce periodic reports every six months. Managers must prepare and publish annual and semi-annual reports, and make them available upon request and free of charge.

In the UK, the FCA has the power to require a manager and/or depositary to compensate an authorised fund in the event of a finding against the manager and/or depositary. It also has the power to fine those entities and to fine or ban individuals in those companies.

In addition, authorised fund management is covered by the Financial Ombudsman Service and the Financial Services Compensation Scheme, which each deal with investor complaints and can require managers to compensate investors in certain circumstances.

3.3.8 Approach of the Regulator

See **2.3.8 Approach of the Regulator**.

3.4 Operational Requirements

The UCITS Directive sets out stringent requirements as to the operation of such funds, including that a depositary must be appointed. The fund must also establish and apply remuneration practices and policies, and publish its remuneration policy.

There are also restrictions on UCITS-compliant retail funds in relation to borrowing and the types of investments such funds can make. Being non-UCITS funds, NURS have greater flexibility, with differing borrowing and investment restrictions, and are popular for real estate investment through the PAIF structure.

3.5 Fund Finance

UCITS funds are subject to prescriptive rules on borrowings, as prescribed under the UCITS Directive. A UCITS is permitted to borrow money for use by the fund, provided it will be repaid out of the scheme property and does not conflict with any restrictions on borrowing that may have been included in the fund's Instrument of Incorporation. This borrowing is permitted purely on a temporary and infrequent basis, and must not exceed 10% of the total value of the fund's assets on any day. Prior consent for any borrowing must be obtained from the Depositary, or for periods of borrowing that may exceed three months. For NURS, the same 10% borrowing limit applies, but there is no restriction on the length of time for which a NURS may borrow. QISs have the ability to borrow up to 100% of the fund's NAV. Where derivatives are used, a QIS must ensure that its total exposure to derivatives does not exceed its NAV.

3.6 Tax Regime

General

See **2.6 Tax Regime** ("General").

OEICs (Other than PAIFs) and AUTs

Tax position of the fund

OEICs and AUTs are subject to UK corporation tax, but are exempt from tax on chargeable gains from the disposal of assets. Furthermore, if these funds satisfy the "genuine diversity of ownership" condition (GDO), then certain capital profits from investment transactions should be treated as exempt capital gains. For the GDO to be met, the fund must be sufficiently widely marketed. An LTAF can also meet the GDO if at least 70% of its shares or units are held by certain institutional investors (or by the manager of the fund in its capacity as manager). Failure to meet the GDO has wider consequences for QISs and LTAFs, such that, broadly, they are taxed under normal corporation tax rules rather than the (more generous) ones that typically apply to authorised funds.

OEICs and AUTs can also potentially benefit from the general exemption from corporation tax on dividends.

OEICs and AUTs must allocate for distribution as dividends or interest the total amount available for income allocation. An OEIC or AUT can only show an amount as available for distribution as interest if it meets the qualifying investments test (such funds are often called "bond funds"). It meets this test, broadly, if the market value of investments that produce interest (or a return similar to interest) exceeds 60% of the market value of the fund's total investments. If this test is met, the distribution is generally allowable as a deductible expense for the fund for corporation tax purposes. If the qualifying investments test is not met, then all of the income available for distribution must be classed as dividends.

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

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

Tax position of the investor

UK tax resident individuals will be taxed on dividend distributions in the same way as for dividends they receive from normal companies. Therefore, UK tax resident individuals will be subject to income tax, at rates of up to 38.1% (set to increase to 39.35% from 6 April 2022). However, for UK corporation tax payers, dividend distributions are streamed into franked and unfranked parts.

Interest distributions are, broadly, treated as interest receipts, so UK resident individuals will be subject to income tax (at rates of up to 45%), and corporation tax payers should treat them as taxable income.

PAIFs

Tax position of the fund

As mentioned above, OEICs that invest in real estate can be structured as PAIFs (provided the necessary conditions are met). PAIFs are subject to a significantly modified version of the OEIC tax regime described above. An important extra benefit of PAIF status is that, broadly, a PAIF is exempt from corporation tax on the net income of its property investment business.

Special streaming rules apply to PAIFs. Broadly, the total amount available for income allocation by a PAIF must be split into three pools comprising property income distributions, interest distributions and dividend distributions. Interest distributions should be deductible expenses for the PAIF when calculating the net income of the non-tax exempt part of its business.

Payments of property income distributions are subject to withholding tax (currently at 20%), unless an exemption applies (for example, if the PAIF has a reasonable belief that the person beneficially entitled to the payment is a UK tax resident company). Depending on its particular circumstances, a non-resident investor may be able to reclaim under a double tax treaty all or part of any tax withheld from property income distributions paid to it. No withholding tax should apply to payments of interest distributions or dividend distributions.

Tax position of the investor

In relation to PAIFs, broadly, for recipients, property income distributions are taxed as profits of a UK property business, so UK resident individuals are subject to income tax on them (at rates of up to 45%) (and credit should be given for tax withheld on payment of the PID). Corporation tax payers will treat them as taxable income.

Interest distributions are, broadly, treated as interest receipts, so UK resident individuals will be subject to income tax (at rates of up to 45%), and corporation tax payers will treat them as taxable income. Dividend distributions are taxed as dividends on shares in the normal way. Therefore, UK tax resident individuals will be subject to income tax, at rates of up to 38.1% (set to increase to 39.35% from 6 April 2022), and corporation tax payers can potentially benefit from the general UK company exemption from tax on dividends.

ACSs

Tax position of the fund

As mentioned above, ACSs can take the form of either co-ownership schemes (CoACSs) or limited partnerships. However, the tax discussion in this chapter is confined to CoACSs, which is the more common ACS structure. CoACSs are transparent for the purposes of the taxation of income, and are not subject to UK taxation of chargeable gains. Distributions to investors from CoACSs should generally not be subject to withholding tax (although withholding may be required if a CoACS has UK property income and non-resident investors).

Tax position of the investor

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

For capital gains purposes, an investor's interest in the underlying assets of the CoACS is disregarded and instead its holding of units in the scheme is treated as an asset.

4. LEGAL, REGULATORY OR TAX CHANGES

4.1 Recent Developments and Proposals for Reform

The UK left the EU on 31 January 2020, and the transition period ended on 31 December 2020. The UK now has its own AIFM and PRIIPs Regimes, which sit alongside the European regimes. Whilst the UK and EU rules remain largely aligned, there may be divergence in the longer term.

This has already been indicated in the case of the PRIIPs Regime. In July 2021, the FCA published a consultation paper on a number of proposed amendments to the UK PRIIPs Regime, relating to the scope rules and changes to the "onshored" Regulatory Technical Standards. The paper was expressly described by the FCA as a consultation on post-Brexit divergence. In terms of timing, the FCA had originally planned to make the final rules and amend the UK PRIIPs RTS by the end of 2021, but has now indicated that it is aiming to publish the Policy Statement in Q1 2022; this will include confirmation of when the rules will take effect and any implementation period. Separately, in October 2021, the exemption in the UK PRIIPs Regulation releasing UK UCITS management companies from having to prepare a PRIIPs-compliant KID was extended by another five years, from 31 December 2021 to 31 December 2026.

The introduction of a new statutory Overseas Funds Regime for non-UK collective investment schemes, including EEA UCITS, is expected to come into effect soon. Under the new regime, non-UK funds will be able to market to UK retail investors if they meet certain criteria and if the FCA has approved the scheme as "recognised". Whilst the legislative amendments to give effect to the new regime were made in 2021, the UK government has not yet published details of when the new regime will be operational.

The FCA published a consultation, which resulted in changes to the Listing Rules relating to special purpose acquisition vehicles (SPACs) from August 2021. The FCA's aim is to provide a more flexible regime, potentially resulting in a wider range of SPACs listing in the UK, as well as increased choice for investors, and its proposals will put the UK regime on a similar footing to the regulatory regimes of competing financial centres.

Many see Brexit as an opportunity to re-evaluate the choice of funds vehicles currently available in the UK and to carve out a more suitable and competitive vehicle for today's markets.

In March 2020, the UK government announced that it would undertake a review of the UK funds regime, covering taxation and relevant areas of regulation. An important measure that has come out of the review is the April 2022 introduction of a competitive new tax regime for asset holding companies that, broadly, are at least 70% owned by investment funds that meet a diversity of ownership condition or by certain institutional investors (such as most pension funds). Improving the tax efficiency of UK resident asset holding companies used by alternative funds may well increase the attractiveness of the UK as a jurisdiction in which to domicile alternative funds themselves, given the practical benefits of having a fund located in the same place as the structure it uses to hold its investments. Also in April 2022, some targeted reforms to the REIT rules will be implemented, designed to increase the attractiveness of that regime.

The funds review also included a wide-ranging call for input (CFI), and the government's response is awaited. Amongst other things, the CFI sought views on the tax treatment of the LTAF and on different options for a flexible, tax-efficient, unauthorised fund structure, capable of investment in alternative asset classes, which would be aimed at professional investors, filling another gap in the current UK offering. The proposals being considered on which the CFI seeks views are structuring the fund as a contractual scheme or as either a corporate entity or a partnership. The tax status of these unauthorised vehicles would be dictated by the legal form of the fund – for example, the tax rules for a new unauthorised contractual scheme would probably be similar rules to the tax regime for CoACSs.

In addition, the CFI sought views on various specific tax issues, including:

- considering whether authorised funds should be exempted from tax altogether;
- exploring whether bespoke partnership taxation rules could provide the opportunity for improved tax administration and certainty of tax outcomes; and
- making changes to the REIT rules (in addition to those due to come into effect in April 2022).

In addition, as part of the funds review, a review of the VAT treatment of fund management fees is expected to be taken forward in 2022.

The FCA's new authorised fund regime for investing in long-term assets came into force in November 2021. The new regime created the LTAF, a type of authorised open-ended AIF designed specifically to facilitate investment in long-term, illiquid assets, such as venture capital, private equity, private debt, real estate and infrastructure. Currently, LTAFs can only be promoted to professional clients, sophisticated investors and (subject to significant qualifications) certain high net worth investors, but the FCA will consult in in the first half of 2022 on their promotion to a broader range of retail investors.

A number of longer term initiatives have also begun. Following a consultation in late 2020, in 2021 HM Treasury published its proposals for reform under the Financial Services Future Regulatory Framework Review, setting out its vision for the future regulatory framework for UK financial services following the UK's departure from the EU.

Developments are also underway that should make it easier for pension funds – and potentially other investors – to access longer term, illiquid investments. That could be excellent news for alternative asset managers, who have been looking hard at ways to widen their investor base. It is also good news for the growing pools of "retail" capital that would like to access the more diversified – and frequently high-performing – funds that have previously been the preserve of institutional investors. In October 2021, the Bank of England published a report by the Product Finance Working Group (PFWG), which considers the key barriers to investment in long-term, less liquid assets, summarising the practical solutions that they have developed, specifically focusing on UK workplace defined contribution pension schemes. Separately, the UK government published a review in 2021 into how aspects of the defined contribution pension scheme "charge cap" can affect the ability of defined contribution schemes to invest in a broader range of assets (including private equity and illiquid infrastructure).

Also in 2021, proposed new UK financial promotions rules were published, including additional rules in respect of high-risk investments, new rules on the approval of financial promotions of unauthorised persons and amendments to certain financial promotion exemptions.

The UK is not required to implement EU legislation that was not in force before 31 December 2020 but in some instances has adopted a similar regime. For example, while the UK is no longer required to implement the EU's prudential regime for MiFID investment firms due to Brexit, the UK has introduced a new UK Investment Firm Prudential Regime (which came into force in January 2022).

Developments in the EU will continue to be relevant to UK fund managers operating in the UK and hoping to market UK funds to investors in the EU. Of particular relevance were the long-awaited publication in November 2021 by the European Commission of its proposed amendments to amend the EU AIFMD (AIFMD II) and of its proposal to amend the existing EU European Long-Term Investment Funds Regulation (ELTIF Regulation). There is currently no indication that the UK is planning to make similar changes.

The UK has continued to chart its own course on sustainability. Following Brexit, it did not implement the EU Sustainable Finance Disclosure Regulation regime (which started applying in the EU in March 2021) and had only "onshored" the most skeletal elements of the EU Taxonomy Regulation (a classification system to identify sustainable investments). Instead, the UK has sought to tailor a wide-ranging, domestic disclosure regime, albeit one based on international standards and with more than a nod to the EU regime. The UK regime is still evolving, although the cornerstone has been laid and the rules governing the mandatory Taskforce on Climate-related Financial Disclosures (TCFD) disclosure requirements are now in force for some of the very largest asset managers, with the first disclosures required in 2022. Most other UK asset managers will be subject to the regime from 2023.

The publication of the GBP and JPY settings of the London Interbank Offered Rate (LIBOR) ceased at the end of 2021. In the build-up to cessation, the FCA encouraged market participants to transition their LIBOR-referencing contracts to “risk free” reference rates (often referred to as RFRs). The Bank of England’s Working Group on Sterling Risk-Free Reference Rates (the RFR Working Group) ultimately recommended the Sterling Overnight Index Average (SONIA) as its preferred replacement rate for LIBOR in sterling markets, although, in some circumstances, the Bank of England Bank Rate has also been deemed an appropriate alternative. The FCA has reported that this transition has largely been successful, but has acknowledged that there are still many agreements that reference LIBOR such that, in order to avoid disruption to the market, the FCA has exercised its powers to require publication of six GBP and JPY LIBOR settings on a changed or “synthetic” methodology (Synthetic LIBOR) for at least 12 months following 1 January 2022.

Travers Smith LLP started with teams of transactional, investment funds and financial services regulatory lawyers dedicated to the private equity sector in the 1990s, and now advises many asset owners and asset managers in the private equity, alternative credit, real estate and infrastructure sectors. The firm has a market-leading cross-practice team of 43 partners representing clients in the private capital sector, who manage more than USD4 trillion of assets. Through its consolidated approach to providing sophisticated legal services across asset management, fund formation and fund transactions, regulatory, tax, transactional M&A and private equity, infrastructure, finance, derivatives, structured products, operational risk and sustainable finance (ESG), the team combines cross-disciplinary specialisms to provide holistic support to these clients on important matters both for the funds that they operate and for their own businesses, as well as on the structuring and raising of new funds. The firm also has very strong relationships with asset owners, such as pension schemes and family offices.

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Sam Kay is a partner in the funds department at Travers Smith LLP and specialises in fund formation work for private funds clients. He has more than 20 years' experience in working on investment funds projects and has been a partner at Travers Smith since 2008. His clients raise funds for private equity strategies (including venture, growth, buyout and PERE), private debt and credit strategies, and in the infrastructure asset class. Sam also advises large asset management platforms on a range of funds-related matters. As well as fund formation work, he advises on GP-led fund restructurings, secondaries transactions, carried interest arrangements and co-investment schemes, and works with institutional investors on their participation in funds. Sam regularly advises on cross-border fund structuring issues.

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