The Asset Management Review

Sixth Edition

Editor
Paul Dickson

The LawReviews

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UNITED KINGDOM

Paul Dickson[1]

I OVERVIEW OF RECENT ACTIVITY

The financial crisis of 2007/2008 continues to reverberate in the UK asset management industry notwithstanding the economic recovery that has taken hold in recent years. There continues to be regulatory and political focus at EU and domestic level on the reform of existing financial regulation to protect market stability and prevent the build-up of systemic risk in the financial system. Large-scale reforms have been, to a large extent, driven by European initiatives, with many new measures originating at EU level; for instance, the Alternative Investment Fund Managers Directive (AIFMD) and the revision of the markets in financial instruments regime (MiFID II). However, the UK authorities have also continued their focus on building fairer and more effective financial markets. The Fair and Effective Markets Review – instigated by HM Treasury and the Bank of England to focus on fixed income, currency and commodity markets – came to a close during 2015, and the outcomes of that review seek to instigate change at both a domestic and international level. The UK Financial Conduct Authority (FCA) also continues to focus its attention on the asset management sector – particular areas of scrutiny over the past year include competition among asset managers and the effectiveness of intermediaries.

The view of the Investment Association (IA)[2] is that asset managers emerged from the financial crisis relatively unscathed. However, a fresh wave of significant economic uncertainty, triggered by the result of the UK's referendum on membership of the European Union, raises concerns about the competitiveness of the UK as a global financial centre going forward. Furthermore, the industry continues to face challenges from the general breakdown of trust in the financial services sector in the wake of the financial crisis. This has been acknowledged by industry bodies, and attempts to build investor trust continue to be evident.[3]

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1 Paul Dickson is a partner at Slaughter and May. The author would like to thank Chris Hurn, Kyle O'Sullivan and Christian Davies for their assistance in preparing this chapter.

2 The IA was formed by a merger between the Investment Management Association and the Investment Affairs Division of the Association of British Insurers in June 2014.

3 The IA, *Asset Management in the UK 2014–2015: The Investment Association Annual Survey*, September 2015.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

i The Financial Services and Markets Act 2000

The main framework for the regulation of asset management activities in the UK is contained in the Financial Services and Markets Act 2000 (FSMA) and various instruments introduced under the powers contained in the FSMA.

Regulated activities

The FSMA regulates the provision of financial services, including investment services, in the UK through the concept of regulated activities that may only be carried out by persons who hold appropriate authorisations or are otherwise able to take advantage of a specific exemption from the usual authorisation requirement.[4] Regulated activities are specified activities set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the Regulated Activities Order)[5] that are carried on by way of business in connection with certain specified investments also listed in the Regulated Activities Order.[6] Specified investments include a wide range of financial products including shares, bonds, government securities, deposits, units in collective investment schemes (CISs) and contracts of insurance. The list of specified activities includes:

a dealing in investments as principal or agent;
b arranging deals in investments;
c managing investments;
d establishing, operating or winding up a CIS;
e managing an alternative investment fund (AIF);
f managing an undertaking for collective investment in transferable securities (UCITS) (see Section III.i, *infra*);[7] and
g advising on investments.

Many investment managers and certain investment fund vehicles in the UK will require FCA authorisation as they are likely to be carrying out regulated activities, such as advising clients on investments, managing investments or dealing in investments as an agent on their clients' behalf. It is a criminal offence, potentially punishable by up to two years in prison and a fine, for any person who is not authorised or exempt to carry out any regulated activity in the UK.[8]

Financial promotion

The FSMA contains a basic prohibition on any person who is not appropriately authorised, acting in the course of business, from communicating an invitation or inducement to engage in investment activity.[9] Investment activity for these purposes includes entering or offering to enter into an agreement, the making or performance of which by either party would be a

4 Section 19 FSMA.
5 SI 2001/544.
6 Section 22 FSMA.
7 Activities (e) and (f) were introduced from 22 July 2013 by the Alternative Investment Fund Managers Regulations 2013. If a person has permission to manage an AIF or a UCITS scheme, they need not obtain permission to operate a CIS in respect of that AIF or UCITS scheme; however, an investment manager that manages AIFs and UCITS schemes must hold permissions for both activities.
8 Section 23(1)(b) FSMA.
9 Section 21(1) FSMA.

regulated activity. However, this prohibition will not apply where an appropriately authorised person has approved the content of the proposed communication or if an exemption to the basic prohibition applies.[10]

CISs

The concept of a CIS is a central part of the system of regulation of asset management vehicles in the UK. These are widely defined in the FSMA to include:

> *[…] any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements […] to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.*[11]

Participants in a CIS must not have day-to-day control over the management of the property.[12] In addition, the relevant arrangements must involve the pooling of participants' contributions and the profits or income out of which payments are to be made to such participants, or the property must be managed as a whole by, or on behalf of, the operator of the scheme,[13] or both.[14] The potentially wide definition of a CIS included in the FSMA is narrowed by the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (the Collective Investment Schemes Order),[15] which excludes, among other arrangements, all bodies corporate (other than open-ended investment companies (OEICs) and limited liability partnerships), contracts of insurance, and occupational and personal pension schemes.[16] A CIS need not have any particular legal form and, subject to the exemptions outlined above, the concept attaches to a wide range of legal vehicles and contractual arrangements.

If an arrangement is classified as a CIS, a number of important regulatory consequences follow. Units (i.e., rights or interests) in a CIS are a specified investment, and establishing, operating or winding up a CIS is a specified activity under the FSMA that requires FCA authorisation.[17] The restrictions on financial promotion summarised above will also become relevant. Furthermore, Section 238 FSMA prohibits authorised persons from promoting or marketing unregulated CISs, such as unauthorised unit trusts (UUTs) and hedge funds,

10 Section 21(2) and 21(5) FSMA. The exemptions to the basic prohibition on financial promotions by unauthorised persons are set out in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (SI 2001/1335) (as amended).

11 Section 235(1) FSMA.

12 Section 235(2) FSMA. The meaning of the term day-to-day control was considered by Laddie J in *Russell Cooke Trust Co v. Elliott* [2001] All ER 197, in which he concluded that the mere fact that investors have a right to be consulted or can give directions to an investment manager of a fund did not necessarily mean that they had day-to-day control over the property of that fund.

13 The glossary in the FCA Handbook makes clear that the term operator means the person or entity responsible for management of the scheme or property within the scheme.

14 Section 235(3) FSMA.

15 SI 2001/1062.

16 Schedule to Article 3, Paragraphs 17, 20 and 21 Collective Investment Schemes Order.

17 Articles 81 and 51ZE Regulated Activities Order.

except in certain circumstances (e.g., where the promotion is made only to investment professionals).[18] The promotion of unregulated CISs, together with certain close substitutes called non-mainstream pooled investments, is prohibited to the majority of retail investors.[19]

ii FCA

The FCA is the conduct-of-business regulator for all authorised firms. It is also responsible for the prudential regulation of all firms not authorised by the Prudential Regulation Authority (PRA). PRA-authorised firms (being, broadly speaking, banks, insurance companies and certain systemically important investment firms) are dual-regulated by the PRA for prudential matters and the FCA in respect of conduct of business. Most investment managers and investment vehicles requiring authorisation are regulated solely by the FCA; however, those deemed to be of significant importance to the UK's wider financial system fall within the ambit of the PRA's supervision.

The FSMA confers a wide range of regulatory functions and powers on the FCA. The FCA's statutory objectives include:

a ensuring that relevant markets function well;
b protecting and enhancing the integrity of the UK financial system;
c promoting effective competition in the markets for regulated financial services in the interests of consumers; and
d securing an appropriate degree of protection for consumers.

Under the FSMA, the FCA has extensive rule and code-making powers; it is permitted to issue such rules that it considers necessary or expedient for the purpose of advancing one or more of its statutory objectives. The rules and guidance applicable to FCA-authorised firms are consolidated in the FCA Handbook, which includes high-level standards, conduct-of-business requirements, regulatory guides and specific specialist sourcebooks applicable to a wide range of asset management vehicles and arrangements.[20] The content of the FCA Handbook is heavily influenced by EU legislation; for instance, the Markets in Financial Instruments Directive (MiFID), which sets out various organisational and conduct-of-business requirements that apply to authorised investment firms.[21] The FCA has recently substantially updated the FCA Handbook to reflect the MiFID II regime, which will come into force in January 2018. Similar rule-making powers are conferred on the PRA, whose rules are set out in the PRA Rulebook.[22]

The FCA makes use of a number of supervisory tools in its oversight of the asset management industry, including thematic reviews and market studies, which involve investigations into key current or emerging risks relating to a specific issue or product.[23] Notably, the FCA recently published the final report on its wide-ranging Asset Management

18 Exemptions from Section 238 FSMA are set out in the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (SI 2001/1060) and the FCA's Conduct of Business Sourcebook (COBS).

19 COBS 4.12.

20 The FCA Handbook is available at www.handbook.fca.org.uk/handbook.

21 See Section III of the European Overview chapter. MiFID is implemented in the UK by way of the regulated activities regime, as set out above, and the FCA rules.

22 The PRA Rulebook is available at www.prarulebook.co.uk/.

23 Recent thematic reviews include a 2015 thematic review about benefits provided and received by firms conducting MiFID business, and those carrying out regulated activities in relation to a retail investment

Market Study in June 2017. The key findings of that study focused on price competition in a number of areas of the asset management industry, fund performance, how asset managers communicate their objectives to clients, and the role of investment consultants and other intermediaries in the asset management sector. Another key area of interest has been potential conflicts of interest between asset management firms and their customers, particularly in relation to the clarity of fund charges and of how commissions charged to customers are spent. The FCA rules and guidance on the use of dealing commission[24] make clear that client commission may only be spent on the actual cost of executing customer orders; goods and services related to execution of trades; and goods and services related to the provision of research. The scope of the exemption relating to research was also been clarified in response to the FCA's concerns that firms were pushing the definition to cover non-eligible services. In particular, the FCA considered that corporate access services, which consist of arranging or bringing about a contact between an investment manager and an issuer or potential issuer, do not constitute research, and that where research services are 'bundled' together with other non-eligible services, only the cost of the eligible research services should be passed on to the customer.[25] Under the changes to the FCA Handbook that will come into effect in January 2018 as a result of MiFID II, firms that provide independent advice or portfolio management will also be prohibited from receiving and retaining payments from third parties.

In March 2017, the FCA published the final report on its Financial Advice Market Review (FAMR). The latter was launched jointly by HM Treasury and the FCA in August 2015 to explore the ways in which government, industry and regulators could stimulate the development of a market that delivers affordable and accessible financial advice and guidance. The final report set out a series of recommendations intended to tackle the barriers to consumers accessing advice and guidance. Those recommendations fall into three key areas: the affordability and accessibility of advice; liabilities of investment advisers; and redress. As part of the implementation of those measures, the report recommended that the FCA and HM Treasury should work together to develop an appropriate baseline and indicators to monitor the development of the advisory market. The FCA published its baseline report in June 2017 and is currently intending to monitor developments in the market and assess the impact of the FAMR recommendations, until it conducts a review of their outcomes in 2019.

III COMMON ASSET MANAGEMENT STRUCTURES

A range of legal vehicles is commonly used for asset management activities in the UK. These include limited companies, trusts and limited partnerships, as well as certain bespoke legal forms specific to the investment funds context. The choice of legal form of an investment fund will often be influenced by the tax treatment of that fund and the regulatory implications for both the fund and the fund manager that follow from that choice.

product, TR 16/3 Meeting of investors' expectations, TR15/1 Asset management firms and the risk of market abuse, TR14/19 Wealth management firms and private banks – conflicts, and TR14/7 Clarity of fund charges.

24 Contained in COBS 11.6 of the FCA Handbook.

25 COBS 11.6.8 and 11.6.8A.

i Open-ended investment vehicles

Open-ended funds issue and redeem securities to and from investors in the fund on an ongoing basis at a price that is based directly on the underlying net asset value of the investment portfolio held by the fund. In the UK, an open-ended investment vehicle may take the form of a UUT or one of three forms of authorised CIS: authorised unit trusts (AUTs), OEICs and authorised contractual schemes. Such authorised CISs may, in turn, be UCITS schemes, non-UCITS retail schemes or qualified investor schemes, as discussed below.

Unit trusts and AUTs

The original form of open-ended fund in the UK is the unit trust. This relies upon the English common law concept of trust, under which a trustee holds the legal title to the trust property on behalf of the beneficiaries (in this case, the investors) who themselves have a beneficial interest in the underlying trust assets. Typically, the trustee will be a financial institution with experience in offering trust services (in the case of AUTs, it is important that the trustee is authorised under the FSMA[26]). However, unlike other general forms of trusts, there will also be a separate fund manager to formulate and implement the unit trust's investment strategy, working alongside the trustee. Trusts themselves do not have any legal personality under English law and therefore cannot contract in their own name. Instead, they are characterised by the trust relationship between the trustee and the beneficiaries, which will be established by the relevant document constituting the trust (which, in the case of unit trusts, is typically termed the 'trust deed').

An AUT scheme is defined in the FSMA as a unit trust scheme authorised in accordance with Section 243 FSMA.[27] The FCA may authorise a unit trust scheme if it is satisfied that the requirements contained in that Section are met, the rules in the FCA's Collective Investment Schemes Sourcebook (part of the FCA Handbook, commonly referred to as COLL) have been satisfied, and it has been supplied with a copy of the trust deed constituting the AUT and a certificate signed by a solicitor that states that the requirements in Section 243 and COLL have been met.

AUTs enjoy two key advantages that flow from FCA authorisation. First, an AUT is able to make invitations or financial promotions to participate in the scheme directly to the public in the UK.[28] Second, AUTs are not liable to pay UK tax on the chargeable gains realised on a disposal of assets in their underlying investment portfolios.[29]

It is possible for unit trusts to be unauthorised, meaning that no FCA approval has been granted under Section 243 FSMA. This has the advantage that the UUT is not subject to the detailed requirements in COLL, but does not benefit from the exemption from the prohibition on financial promotions to the public in the UK and, unless all of the investors in the UUT are exempt from UK tax on capital gains other than by reason of residence or the UUT benefits from pre-6 April 2014 grandfathering, it will broadly be taxed as though it was a UK-resident company. This tends to mean that unauthorised trusts are attractive to a narrower range of professional investors and are unsuitable for use as retail investor schemes.

26 Acting as trustee of an AUT is a specified activity under Article 51ZB (in relation to UCITS schemes) or Article 51ZD (in relation to AIFs) of the Regulated Activities Order, as applicable.

27 Section 237(3) FSMA.

28 Section 238(4)(a) FSMA, which disapplies the general restriction on the promotion of CISs in Section 238(1).

29 Section 100 Taxation of the Chargeable Gains Act 1992.

OEICs

OEICs were introduced in the UK partly as a response to the unfamiliarity of overseas investors with the trust structure underlying unit trusts. They represent a compromise position in English law by permitting a company to have a variable capital structure.[30] In many ways, OEICs are similar to AUTs (the statutory and regulatory provisions applying to both often use similar wording and concepts), but OEICs are bodies corporate and therefore have separate legal personality. As a result, OEICs are not based on the English law concept of the trust, and the OEIC itself will hold the beneficial interest to the investment portfolio (while the investment assets must be entrusted to a depositary, which will hold legal title to them[31]). Therefore, the investors in an OEIC are, to an extent, in a similar position to shareholders in a traditional limited company. An OEIC must also have an authorised corporate director that will assume responsibility for the OEIC's ongoing operating duties.[32] Although an OEIC may theoretically have additional directors, this is rare in practice, and it is far more common for the authorised corporate director to be the sole director of the OEIC.

The Treasury is empowered under the FSMA to make rules that regulate OEICs,[33] and the current regulatory framework operates through two distinct sets of regulations: the Open-Ended Investment Companies Regulations 2001 (the OEIC Regulations)[34] and those parts of COLL relevant to OEICs. OEICs are not regulated by the general company law provisions contained in the Companies Act 2006, despite their status as bodies corporate under English law.

The formation of OEICs is governed by Part II of the OEIC Regulations, which states that an OEIC is incorporated upon the coming into effect of an authorisation order from the FCA.[35] Since the only method of incorporating an OEIC is through this FCA authorisation procedure, it is not possible to have an unauthorised OEIC in the UK (unlike a unit trust, which may be either authorised or unauthorised).

To grant authorisation, the FCA must be provided with a copy of the company's instrument of incorporation and a certificate from a solicitor that attests that the instrument of incorporation complies with FCA requirements, including the inclusion of certain key statements and matters set out in Schedule 2 to the OEIC Regulations.[36] As with AUTs, OEICs must also permit shareholders to have their shares redeemed or repurchased

30 Traditionally, English company law has resisted the idea of companies having variable capital, and has imposed relatively strict maintenance of capital rules that have prevented companies from being suitable open-ended investment vehicles. Prior to the development of OEICs, closed-ended investment trusts (which are actually companies under English law) were the typical form of body corporate employed as a collective investment vehicle.

31 Regulation 5 OEIC Regulations.

32 See Chapter 6 of COLL, which sets out the ongoing operating duties and responsibilities of the authorised corporate director of an OEIC.

33 Section 262 FSMA.

34 SI 2001/1228.

35 Regulation 3(1) OEIC Regulations.

36 These include, for example, that the OEIC's shareholders are not liable for its debts (Paragraph 2(c)), and that the charges and expenses of the OEIC may be taken out of the scheme property (Paragraph 2(e)). In addition, the instrument of incorporation must contain provisions stating the object of the OEIC (Paragraph 3(1)(a)), the currency in which its accounts are to be prepared (Paragraph 3(1)(c)), the maximum and minimum sizes of its capital (Paragraph 4(1)(c)), and the rights attaching to each class of its shares (Paragraph 4(1)(f)).

on request at a price related to the net value of the OEIC's investment portfolio and determined in accordance with the OEIC's instrument of incorporation and the rules in COLL.[37] Alternatively, or in addition, shareholders must be entitled to sell their shares on an investment exchange at a price that is not significantly different from the redemption or repurchase price.[38] UK OEICs are not subject to the restriction on the promotion of CISs contained in Section 238 FSMA.[39]

Authorised contractual schemes

The Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013 (the Contractual Scheme Regulations) came into force on 6 June 2013.[40] The Contractual Scheme Regulations provide for a new form of authorised CIS: an authorised contractual scheme (ACS). Previously, collective investment activity authorised by the FCA could only be carried out through AUTs or OEICs, neither of which are tax transparent (although neither AUTs or OEICs are generally liable to pay UK tax on the chargeable gains realised on the disposal of investment assets, nor are they generally liable to pay UK tax on their dividend income). ACSs, on the other hand, are tax-transparent collective investment vehicles, meaning that they are not within the charge to direct taxes and that any tax liability is at the investor level. The introduction of ACSs is intended to increase the competitiveness of the UK's asset management industry.

The ACS may take the form of a co-ownership scheme or a limited partnership scheme.[41] An ACS is defined in the FSMA as a contractual scheme that is authorised in accordance with Section 261D(1) FSMA.[42] The FCA may authorise a contractual scheme if:

a it is satisfied that the scheme complies with the requirements of Sections 261D and 261E FSMA;

b the scheme meets the requirements of the contractual scheme rules (set out in COLL); and

c it has been provided with a copy of the contractual scheme deed and a certificate signed by a solicitor stating that the deed complies with the necessary requirements.[43]

The general restriction on the promotion of CISs does not apply to ACSs.[44] However, to protect retail investors, the ACS must not allow retail investors to be participants in the scheme unless they invest £1 million or more.[45]

UCITS schemes

UCITS schemes are not a separate type of open-ended investment vehicle, but rather they are AUTs, OEICs or ACSs that meet the criteria laid down in the UCITS IV Directive

37 Regulation 15(11)(a) OEIC Regulations.

38 Regulation 15(11)(b) OEIC Regulations.

39 Section 238(4)(b) FSMA disapplies the general restriction on the promotion of CISs in Section 238(1) FSMA.

40 SI 2013/1388.

41 Section 235A FSMA.

42 Section 237(3) FSMA.

43 Section 261D(1) FSMA.

44 Section 238(4)(aa) FSMA disapplies the general restriction on the promotion of CISs in Section 238(1).

45 Section 261E FSMA.

(the UCITS Directive). The UK has implemented the requirements of the UCITS Directive primarily through the FCA's COLL sourcebook, and the insertion and amendment of certain provisions in the FSMA by the UCITS Regulations 2011.[46]

A UCITS scheme must comply with the following criteria:

a it must be an AUT, an OEIC or an ACS;

b the sole object of a UCITS scheme must be collective investment in transferable securities[47] or in other permitted financial instruments[48] operating on the principle of risk-spreading; and

c the units in the fund must, at the request of the unitholders, be repurchased or redeemed, directly or indirectly, out of the scheme's assets (which includes action taken by or on behalf of the scheme on a stock exchange to ensure that the value of its units does not vary significantly from their net asset value).

Alternatively, a UCITS scheme may be an umbrella scheme, having sub-funds that each would be a UCITS scheme if they had separate FCA authorisation.

A scheme will not constitute a UCITS scheme for the purposes of the rules in the FCA Handbook if its instrument of incorporation (for an OEIC), trust deed (for an AUT) or contractual scheme deed (for an ACS) contain a provision that means that its units may only be sold to the public in non-European Economic Area (EEA) states.

UCITS schemes must comply with the general obligations applicable to UCITS funds under the UCITS Directive,[49] as well as specific investment and borrowing powers rules.[50] The general UCITS investment limits have been incorporated into the UK regulatory regime through COLL, and include spread limits and specific rules for government securities and for derivatives.[51] The investment powers and borrowing limits for UCITS feeder funds are also included in COLL; these include a general obligation that a feeder UCITS must invest at least 85 per cent in value of its property in units of a single master UCITS.[52]

UCITS schemes must comply with a more stringent regulatory regime; however, they may benefit from cross-border passporting, which allows a UCITS authorised in one EEA state to market its units into any other EEA state. Provisions allowing for the cross-border marketing of UCITS schemes of other EEA states are included in the rules for recognised overseas schemes in COLL 9 and in Section 264 FSMA. The competent authorities of the

46 SI 2011/1613.

47 Transferable securities are defined in COLL 5.2.7 as shares, debentures, alternative finance investment bonds, government and public securities, warrants or certain certificates conferring contractual or property rights in connection with such securities. However, under COLL 5.2.7(2), investments will not constitute transferable securities if the title to them cannot be transferred, or cannot be transferred without third-party consent (except, in the case of a body corporate, any consent required by the body corporate itself, its members or its debenture holders, which may be excluded under COLL 5.2.7(3)).

48 COLL 5.2.6A sets out the permitted types of property that may be included in the portfolio of a UCITS scheme. This includes transferable securities, approved money-market instruments (broadly speaking, liquid instruments normally traded on money markets), units in CISs, derivatives and forward transactions, and deposits. In the case of OEICs, this also includes any moveable or immoveable property that is essential for the direct pursuit of the OEIC's business.

49 COLL 1.2.2 and COLL 3.2.8.

50 COLL 5.2 to COLL 5.5.

51 COLL 5.2.

52 COLL 5.8.2.

home Member State of the relevant UCITS fund are required to notify the FCA that the fund has been authorised under the UCITS Directive in that Member State, following which the fund will have the right to begin marketing units in the UK immediately.

COLL also contains the UK rules on UCITS management company passports, both in respect of UK UCITS management companies operating other EEA UCITS schemes and EEA UCITS management companies acting as authorised fund managers of UK UCITS schemes.[53] The rules applicable to UK management companies make clear that they are subject to a range of general compliance and conduct requirements contained in COLL and in the FCA's conduct of business rules, but they also make clear that where a UK management company operates a UCITS scheme through a branch in another EEA state, it will be subject to the relevant requirements of that state's regulatory authorities so that in certain situations, regulatory responsibility may be shared between the FCA and that state's competent authorities.[54] The rules relating to EEA management companies that operate a UK UCITS (either through a branch or under a general cross-border passport) set out the requirements for certain information to be provided to the FCA in relation to depositary and delegation arrangements,[55] and the rules in COLL and the conduct of business rules to which the EEA management company is subject.[56] These include detailed rules on the issue and redemption of units in a UCITS scheme, investment policies and limits, the calculation of the value of the scheme property, the distribution of income, disclosure and reporting requirements, and marketing requirements.

Non-UCITS retail schemes

Like UCITS schemes, non-UCITS retail schemes (NURSs) are not a separate type of investment vehicle, but rather are AUTs, OEICs or ACSs that do not comply with the requirements to be UCITS. The regulatory regime applying to NURSs in the UK is less stringent than that which applies to UCITS, and the applicable investment restrictions are therefore more relaxed. However, as a consequence, NURSs will not qualify for EU cross-border passporting under the UCITS regime.[57] For example, NURSs are permitted to invest up to 20 per cent of the value of the scheme property in unlisted securities or unregulated investment schemes, and may also invest in gold and real estate assets.[58] In addition, the limit for investment in the units of another authorised scheme is 35 per cent of the NURS's assets[59] (which permits a higher level of investment concentration than the 20 per cent limit applicable to UCITS schemes[60]), while the limit for a NURS's exposure to a single counterparty in an over-the-counter derivative transfer is limited to 10 per cent of the scheme value,[61] rather than the usual 5 per cent limit for UCITS schemes.[62]

53 COLL 12.
54 COLL 12.2.
55 COLL 12.3.4.
56 COLL 12.3.5.
57 See the guidance in COLL 5.6.2.
58 COLL 5.6.4 and COLL 5.6.5.
59 COLL 5.6.7(6).
60 See COLL 5.2.11(9).
61 COLL 5.6.7(5).
62 COLL 5.2.11(7) (although the limit for UCITS schemes is raised to 10 per cent if the derivative counterparty is a financial institution recognised by the FCA rules as an approved bank).

Nonetheless, there are still important limitations on the investment powers of NURSs that are intended to retain a degree of investor protection in the absence of the demanding UCITS requirements. A NURS (except for a feeder NURS[63]) cannot invest in the units of a CIS unless that CIS meets certain minimum requirements, including that:

a the CIS is effectively subject to an equivalent level of regulation as a NURS or UCITS fund (or otherwise that no more than 20 per cent by value of the NURS's assets are invested in that CIS);

b the CIS operates on the principle of the prudent spread of investment risk; and

c the CIS is prohibited from having more than 15 per cent in value of its property in units in other CISs.[64]

NURSs are also subject to certain of the same provisions in COLL that limit the amount of cash that can be retained in the scheme property,[65] general borrowing powers,[66] the ability to lend money and other property,[67] and the power to provide guarantees or indemnities.[68]

Funds of alternative investment funds

COLL includes provisions governing the operation of funds of alternative investment funds (FAIFs) that are NURSs (or sub-funds of umbrella NURSs) operated in accordance with specific rules set out in COLL 5.7 (some of which incorporate general rules that are applicable to all NURSs from COLL 5.6). The regulatory regime for FAIFs is therefore essentially a relaxed version of the rules that apply to NURSs, providing increased flexibility in respect of investment powers.

The key attribute of FAIFs is that they are permitted to invest all of their assets in CISs, provided that those CISs prudently spread risk and do not themselves invest more than 15 per cent in value of their assets in units in CISs (or, in the absence of any such restriction, provided that the fund manager of the FAIF is satisfied on reasonable grounds that no such investment will in fact be made).[69] There is no requirement that the CIS in which a FAIF invests must itself be subject to the rules governing NURSs or the UCITS requirements. However, the fund manager of a FAIF must carry out appropriate due diligence on any CIS in which the FAIF intends to invest.[70] The guidance in COLL 5.7 makes clear that this due diligence should include an assessment of, among other factors, the experience and qualifications of the CIS's investment manager, the adequacy of the CIS's governance arrangements and risk management processes, the level of liquidity and the redemption policy offered by the CIS, and any relevant conflicts of interest between the CIS's investment manager and any other parties.[71]

63 A feeder NURS is a NURS that invests in units only in a single CIS that is itself a NURS, a UCITS scheme or a recognised overseas scheme.

64 COLL 5.6.10.

65 COLL 5.5.3.

66 COLL 5.5.4(1)–(3) and (8), although significantly a NURS's borrowing powers are not limited only to borrowings on a temporary basis, as COLL 5.5.4(4) and (5) do not apply to a NURS.

67 COLL 5.5.6 and COLL 5.5.7(1), (2) and (4).

68 COLL 5.5.9.

69 COLL 5.7.2 and COLL 5.7.7.

70 COLL 5.7.9.

71 COLL 5.7.11.

Qualified investor schemes

As with UCITS schemes and NURSs, qualified investor schemes (QISs) are not a specific legal form of investment vehicle. Rather, QISs are authorised CISs that are designed to be marketed only to certain types of sophisticated investors,[72] rather than to general retail customers, and the fund manager of a QIS is required to take reasonable care to ensure that the units in the QIS are sold only to such persons.[73]

The regulation of QISs is more relaxed than that of UCITS schemes and NURSs, and QISs have greater flexibility in respect of their investment and borrowing powers. The assets in which a QIS invests must be permitted investments under the QIS's constitution and its marketing prospectus,[74] but otherwise they can consist of a wide range of assets including shares, debentures, alternative finance bonds, real estate, precious metals, exchange-traded commodity contracts, options, contracts for difference and units in CISs.[75] Unlike UCITS schemes and NURSs, there are no specific rules that would limit concentration of a QIS's assets in certain investments (except for units in certain CISs), although there is a general requirement that the fund manager of a QIS must take reasonable steps to ensure that the investments provide a suitable spread of risk in light of the investment objectives of the scheme.[76] In relation to investments in CISs, a QIS may only invest in regulated CISs or schemes that otherwise meet certain minimum requirements (and if the scheme is of the latter type, the QIS must not invest more than 20 per cent in value of its assets in unregulated schemes or other QISs unless the fund manager has taken reasonable care to ensure that the target scheme complies with all relevant legal and regulatory requirements).[77]

The limitations on the borrowing powers of QISs are similarly relaxed. There is a general rule that the borrowing of a QIS must not exceed 100 per cent of the value of its assets and the fund manager must take reasonable care to ensure that arrangements are in place that will enable borrowings to be closed out to ensure compliance with that rule.[78] However, there is no requirement that borrowings can only be of a temporary nature.

ii Closed-ended investment vehicles

Closed-ended funds differ from open-ended funds by issuing a fixed number of securities, usually determined by the fund's constitutional documents or by the general requirements of the law regulating the type of fund entity, or both, with investors realising their investment either by selling the securities in the secondary market or upon the winding-up of the fund at the end of its life. Therefore, unlike open-ended funds, closed-ended funds do not undergo the constant expansion and contraction of the number of securities in issue throughout their life in response to ongoing investment and redemption. In the UK, the most common closed-ended structures are investment trusts (which are actually companies) and partnerships.

72 QISs fall within the definition of non-mainstream pooled investment and therefore are subject to the marketing restrictions in COBS 4.12 (see Section II.i, *supra*).

73 COLL 8.1.3.

74 COLL 8.4.3.

75 COLL 8.4.4.

76 COLL 8.4.2.

77 COLL 8.4.5.

78 COLL 8.4.10.

Investment trusts

Investment trusts, despite their misleading name, are not trusts, but rather are public limited companies that are listed on a recognised stock exchange. As such, the usual company law provisions contained in the Companies Act 2006 apply to investment trusts, and there is no separate legal regime governing their form and structure (e.g., as there is for OEICs). However, to constitute a valid investment trust for tax purposes, a company must meet the criteria set out in Section 1158 of the Corporation Tax Act 2010.

Unlike open-ended funds, the shares in an investment trust may trade at a discount or a premium to the net asset value of the company's underlying assets, depending on levels of supply and demand on the stock exchange. It is usual for the shares of investment trusts to trade at a discount, which can lead to considerable time being spent on attempting to manage the level of this discount. In particular, investment trusts commonly seek general shareholder authority (usually on an annual basis) to make purchases of their own shares in the market from time to time in order to support the price at which their shares trade.

As listed entities, investment trusts are subject to the Listing Rules (LRs) that form part of the FCA Handbook and are published by the FCA acting in its capacity as the UK Listing Authority. In particular, Chapter 15 of the LRs contains specific rules with which listed closed-ended investment funds (which includes investment trusts) must comply.[79] In addition to meeting the minimum requirements for listing that apply to all listed securities, the LRs stipulate that investment trusts must invest and manage their assets in such a way as to spread investment risk,[80] and that the board of directors of the investment trust must be able to act independently from its investment manager.[81] In addition, an investment trust must make investments in accordance with a published investment policy, and any material changes to that policy must be approved by shareholders and, if the change is not proposed to enable the winding-up of the investment trust, by the FCA.[82]

Investment trusts themselves do not require authorisation under the FSMA. However, following the implementation of the AIFMD, managers of investment trusts either require FCA authorisation or, in certain limited instances, to be registered with the FCA to carry out the activity of managing the investment trust. Investment trusts have a board of directors, but management is usually delegated to an investment management company; this external manager must therefore be authorised and comply with the requirements of the AIFMD. If the investment trust is internally managed, the investment trust itself must be authorised or registered.

Under the Collective Investment Schemes Order,[83] investment trusts do not qualify as CISs, and therefore the restrictions on the promotion of CISs in Section 238 FSMA do not apply.[84] However, shares in an investment trust will constitute specified investments under Article 76 of the Regulated Activities Order, and therefore they fall within the general restrictions on financial promotions.

79 Although LR 15 is stated to apply only to closed-ended investment funds with a premium listing, LR 1.5.1 makes clear that investment trusts will require a premium listing for their equity shares.

80 LR 15.2.2.

81 LR 15.2.11.

82 LR 15.4.2 and LR 15.4.8.

83 SI 2001/1062.

84 See Paragraph 21 of the Schedule to the Collective Investment Schemes Order.

Limited partnerships

Limited partnerships are formed under the Partnership Act 1890 and registered under the Limited Partnerships Act 1907 (LPA 1907). A limited partnership is defined as consisting of one or more general partners who are liable for all the debts and obligations of the partnership, and one or more limited partners whose liability is limited to the amount of capital that they contribute.[85] It is a key requirement of limited partnerships that the general partner alone is responsible for the day-to-day operation and management of the partnership's affairs – if a limited partner becomes involved in the management of the partnership's business, that limited partner will lose the benefit of limited liability and will be treated as a general partner.[86] For this reason, in the asset management context it is usual that an entity connected with the investment manager of a fund that is established as a limited partnership acts as general partner or that management responsibility is delegated to a third party, while investors act as limited partners.

Limited partnerships must be registered with the Registrar of Companies (which acts, for these purposes, as the Registrar of Limited Partnerships) in accordance with the provisions of the LPA 1907.

English limited partnerships do not have separate legal personality, and therefore cannot hold property or contract in their own name. Scottish limited partnerships differ in this respect: Section 4(2) of the Partnership Act 1890 makes it clear that a Scottish partnership is a legal person distinct from the persons of whom it is composed. Both English and Scottish limited partnerships benefit from generally being transparent for tax purposes (see Section VII, *infra*, for further information). In July 2015, HM Treasury consulted on proposed changes to the LPA 1907 as it applies to funds by a Legislative Reform Order. It stated that it remains committed to exploring the possibility of allowing English limited partnerships to elect for legal personality, but that such a change would be fundamental and hence would not be possible using the proposed Legislative Reform Order. Further work will be needed to explore the implications and legislative changes required.[87]

Limited partnerships benefit from flexible governance arrangements, as the LPA 1907 contains few rules on the division of responsibilities between the general and limited partners (other than the overriding requirement that the limited partners must not become involved in the day-to-day management of the partnership business). The general law relating to partnerships is flexible, and it is entirely possible to establish a partnership (although not a limited partnership, owing to the need for registration) without a written partnership agreement. In reality, investment funds will be constituted through a written agreement that sets out the rules and arrangements for that particular partnership. Certain changes to the regime for limited partnerships are proposed by HM Treasury, in particular an ability for a limited partnership to be designated as a private fund limited partnership that would carry certain regulatory benefits. The timescale within which these changes will be brought about remains unclear.[88]

Most investment funds operated as limited partnerships will be CISs within the definition under Section 235 FSMA, as they will involve the pooling of investment assets

85 Section 4 LPA 1907.

86 Section 6(1) LPA 1907.

87 HM Treasury consultation on draft legislation, *Proposal on using Legislative Reform Order to change partnership legislation for private equity investments*, July 2015.

88 Ibid.

in an arrangement whereby investors do not have day-to-day control over the management of the fund's property. In addition, such limited partnerships are likely to be AIFs for the purposes of the AIFMD (see subsection iii, *infra*). As a result, the fund manager (whether this be the general partner or a third-party manager) is likely to require FCA authorisation for the regulated activity of establishing, operating or winding up a CIS or for the regulated activity of managing an AIF.

Private fund limited partnerships

The private fund limited partnerships (PFLP) regime came into force on 6 April 2017 pursuant to the Legislative Reform (Private Funds Limited Partnerships) Order 2017 (the PFLP Order), which amended the LPA 1907 in certain respects. The PFLP regime is the result of the government's initiative to make the UK a more competitive jurisdiction for fund formation by relaxing or removing some of the more burdensome requirements of the LPA 1907 in relation to such funds, while retaining the flexibility and fiscal advantages of limited partnership structures.

A limited partnership must apply to be designated as a PFLP before it can avail itself of the PFLP regime. To be a PFLP, a limited partnership must satisfy two conditions: (1) it must be constituted by an agreement in writing; and (2) it must be a CIS (as defined in Section 235 FSMA, but ignoring any order made under Section 235(5) FSMA).

The PFLP regime relaxes a number of rules relating to limited partnerships as they apply to PFLPs. In particular, the regime introduces a non-exhaustive 'white list' of permitted activities that limited partners may undertake without jeopardising their limited liability status (such as consulting or advising with a general partner or any person appointed to manage or advise the partnership about the affairs of the partnership or about its accounts).[89] The PLFP regime also removes the requirement for partners to make a capital contribution to the partnership, and it removes certain other administrative burdens, such as the need to advertise changes to the partnership in the Gazette. Given that the PFLP Order overlays existing limited partnership law, it has the advantage of maintaining most of the features of the existing limited partnership law that are familiar to investors and asset managers. Crucially, the tax status of the limited partnership is not affected by the PFLP Order.

Limited liability partnerships

Limited liability partnerships (LLPs) are a relatively recent introduction in the UK, having been created by the Limited Liability Partnerships Act 2000. They are a form of hybrid legal entity that are bodies corporate with their own legal personality,[90] but that enjoy the organisational flexibility and tax transparency of traditional partnerships coupled with limited liability for each member. LLPs must be incorporated through the Registrar of Companies.[91]

It is possible for an investment fund incorporated as an LLP to constitute a CIS under Section 235 FSMA in circumstances where the investors do not have control over the day-to-day management of the property of the LLP.[92] In practice, this will depend upon how the

89 Section 6A(2)(i) LPA 1907 (amended by the PFLP Order).

90 Section 1(2) Limited Liability Partnerships Act 2000. As such, they may hold property and enter into contracts in their own name.

91 Section 3 Limited Liability Partnerships Act 2000.

92 LLPs are specifically excluded from being able to take advantage of the general exclusion for bodies corporate in Paragraph 21 of the Schedule to the Collective Investments Schemes Order.

LLP is established and operates. Unlike limited partnerships, every member of the LLP is capable of being involved in its day-to-day operation. Similarly, FCA guidance confirms that it is possible for LLPs to fall within the definition of an AIF under the AIFMD.[93] In such cases, the appropriate FCA authorisation will be required.

iii Alternative investment funds

The UK implementation of the AIFMD, by means of the Alternative Investment Fund Managers Regulations 2013 (the AIFM Regulations),[94] has resulted in a further regulatory category for investment funds: alternative investment funds (AIFs). An AIF is a collective investment undertaking[95] that raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors and that is not a UCITS scheme.[96]

Like UCITS schemes, AIFs are not a separate type of investment vehicle. Rather, the AIFMD regime constitutes a further layer of regulation applicable to managers of investment funds that meet the definition above. An AIF can be open-ended or closed-ended, and constituted in any legal form, including under a contract, by means of a trust or under statute.[97] This broad definition of AIF means that many of the categories of investment fund described above and below fall within its scope, including authorised CISs that are NURSs or QISs, investment trusts, hedge funds, real estate funds and private equity funds. The majority of pension funds (unless they are co-investing with other pension funds) and all insurance funds are excluded. Where a fund does constitute an AIF, the fund itself will remain regulated in the manner set out above, but the manager of such a fund will be regulated pursuant to the AIFMD (although some obligations may indirectly affect the way in which the manager operates AIFs).

Although the implications of the AIFMD for the AIFs themselves may be relatively minor, the impact on alternative investment fund managers (AIFMs) is far greater. An AIFM is defined as a legal person, the regular business of which is managing one or more AIFs.[98] Managing an AIF means performing at least risk management or portfolio management for the AIF.[99] The AIFM may be an external manager or, if the legal form of the AIF permits internal management, the AIF itself.[100]

The various requirements of the AIFMD have been incorporated into the UK regulatory regime through the AIFM Regulations and changes to FCA rules and guidance, including the introduction of the Investment Funds sourcebook (FUND). There is a degree of temporary overlap, in that managers of NURSs and QISs who are authorised as AIFMs must refer to the new sourcebook as well as to COLL. Where there is a conflict between

93 The FCA's Perimeter Guidance Manual (PERG) 16.2, question 2.2.

94 SI 2013/1773.

95 PERG provides further guidance on the definition of a collective investment undertaking. Broadly, the following characteristics should, if all apply, show that an undertaking is a collective investment undertaking: it does not have a general commercial or industrial purpose; it pools together capital raised from its investors with a view to generating a pooled return; and the investors, as a collective group, have no day-to-day discretion or control.

96 Regulation 3(1) AIFM Regulations.

97 Regulation 3(2) AIFM Regulations.

98 Regulation 4(1) AIFM Regulations.

99 Regulation 4(2) AIFM Regulations.

100 Regulation 4(3) AIFM Regulations.

a rule implementing the AIFMD and another rule in the FCA Handbook, the AIFMD requirements will prevail.[101] The AIFMD Level 2 Regulation,[102] which is directly applicable in the UK, contains further detailed requirements relating to certain matters, including the calculation of assets under management and leverage, transparency and operating conditions.

Authorisation

An AIFM must be authorised under Part 4A FSMA to carry on the regulated activity of managing an AIF. To be authorised under Part 4A, the AIFM must comply with a number of obligations, including the following:

a an initial capital requirement.[103] For an internally managed AIFM, this is at least €300,000, while an external manager must have an initial capital of at least €125,000, plus an additional amount of capital calculated on the basis of its assets under management.[104] Most asset management companies already hold substantial capital pursuant to the relevant EU capital requirements rules;[105] however, this was a new requirement for private equity funds;[106]

b the AIFM must be the only AIFM of each AIF it manages;

c the persons who conduct the business of the AIFM must be of sufficiently good repute and sufficiently experienced; and

d the shareholders or members of the AIFM must be suitable taking into account the need to ensure prudent management.

The AIFMD allows for managers of portfolios of AIFs the value of whose assets under management does not exceed €100 million, or €500 million where each managed AIF is unleveraged and has a lock-in period of five years (small AIFMs),[107] to be subject to a lighter regulatory regime.

Full-scope UK AIFMs authorised under Part 4A are subject to the full requirements of the AIFMD as set out in the AIFM Regulations and FUND. Small AIFMs may also be authorised to carry out the regulated activity of managing an AIF; however, certain small AIFMs that meet the conditions in Regulation 10 AIFM Regulations need not be authorised under Part 4A and need only be registered as a small registered UK AIFM.[108] Small AIFMs are not required to comply with the requirements of the AIFMD, with the exception of certain registration, reporting and notification requirements contained in Article 3 of the

101 FUND 1.1.2.

102 Regulation 231/2013.

103 Regulation 5(3)(c) AIFM Regulations and Article 9 AIFMD.

104 Article 9 AIFMD.

105 See Section VII.ii of the European Overview chapter.

106 HM Treasury, *Transposition of the Alternative Investment Fund Managers Directive*, January 2013.

107 Regulation 9 AIFM Regulations.

108 Broadly, Regulation 10 allows for the registration of internally managed, closed-ended investment companies (such as investment trusts); external managers of certain property funds; and managers of European Social Entrepreneurship Funds and European Venture Capital Funds. Schedule 8 of the Regulated Activities Order provides for small registered UK AIFMs to be excluded from the regulated activity of managing an AIF.

AIFMD.[109] As a consequence, small AIFMs do not benefit from the AIFMD's managing and marketing passports unless they opt in to meet the full requirements of the AIFMD. A small authorised UK AIFM will also be subject to the relevant parts of the FCA Handbook.

A UK AIFM may manage a non-EU AIF that is not marketed in the EU provided that it complies with the AIFMD (with the exception of the requirements for a depositary and annual report). There must also be appropriate cooperation arrangements in place between the FCA and the supervisor in the country in which the AIF is established. Provisions requiring non-EU AIFMs to be authorised are expected to come into force when the passport becomes available (see Section III.iii, *infra*).

Prudential and conduct of business requirements

AIFMs must comply with a number of conduct, organisational and prudential requirements.

In particular, AIFMs must implement adequate risk management systems, including by monitoring liquidity risk for each AIF under management and setting a maximum level of leverage.[110] AIFMs must also have adequate procedures and policies in relation to conflicts of interest.[111]

The most significant and controversial additions to the FCA's prudential and conduct of business rules are the AIFMD requirements relating to remuneration, delegation and depositaries. These are more restrictive than previous requirements.

AIFMs must establish, implement and maintain remuneration policies that promote effective risk management and apply to, *inter alia*, any senior managers and other staff whose professional activities have a material impact on the risk profiles of the AIFM or AIFs under management.[112] There are also restrictions on the levels of remuneration paid to such staff: at least 40 per cent of variable remuneration (i.e., bonuses) must be deferred for a period of at least three to five years unless the life cycle of the AIF concerned is shorter than this period. If the bonus is particularly high, at least 60 per cent must be deferred.[113]

In respect of delegation, there are a number of restrictions.[114] An AIFM must notify the FCA before any delegation arrangements become effective, and the AIFM must be able to justify the delegation objectively.[115] The AIFM must not delegate its functions to the extent that it becomes a letterbox entity, and the services provided by the delegate must be reviewed on an ongoing basis. The AIFM's liability towards the AIF and its investors is not affected by the AIFM delegating its functions to a third party or by any further sub-delegation. The meaning of letterbox entity has been the subject of considerable debate. Article 82 AIFMD Level 2 Regulation (reproduced in FUND 3.10.9) lists a number of non-exhaustive situations in which an AIFM will be deemed a letterbox entity and not the manager of the AIF.

AIFMs must appoint a single depositary for each AIF, and the assets of the AIF must be entrusted to the depositary for safekeeping.[116] Rules and guidance relating to the use of such

109 These reporting requirements are contained in the FCA's Supervision Sourcebook (SUP) 16.18.

110 FUND 3.6.3 and 3.7.

111 Senior Management Arrangements, Systems and Controls (SYSC) 10.1.

112 SYSC 19B.1.2 and 19B.1.3.

113 SYSC 19B.1.18.

114 FUND 3.10.

115 FUND 3.10.2.

116 FUND 3.11.4.

depositaries are set out in FUND 3.11. AIFMs must also ensure the proper valuation of AIF assets, conduct at least annual valuations (either internally or through an independent valuer) of the assets of each AIF and disclose the results of the valuation to investors.[117]

Transparency and disclosure

The AIFMD requires certain information to be made available to investors and the FCA by AIFMs. A UK AIFM must disclose specified information to investors (set out in FUND 3.2) for each AIF that it manages or markets, both prior to investment and on a periodic basis thereafter. For instance, it must disclose the investment strategy of the AIFM, a description of the AIF's risks and risk management, and a description of all fees that are borne directly or indirectly by investors.

The AIFM must also make an annual report available to investors[118] and regularly report to the FCA on the matters set out in FUND 3.4 (including the main instruments in which it is trading, its risk profile and, if the AIF employs leverage on a substantial basis, details of the level of leverage employed). Managers of private equity funds and hedge funds, among others, may have to report significantly more information to their investors under this regime than they previously had to.

Private equity provisions

An AIFM must notify the FCA when an AIF that it manages acquires, disposes of or holds significant holdings in a non-listed company.[119] Further, when an AIF acquires, individually or jointly, control of a non-listed company, its AIFM must notify the company, the company's shareholders and the FCA, and must make various disclosures as to the intentions of the AIF with regard to the future business of the company.

In addition, there are asset-stripping provisions whereby the AIFM must use its best efforts to prevent any distributions, capital reductions, share redemptions or the acquisition by the company of its own shares in the first two years after the AIF acquires control.[120] This restriction is subject to certain qualifications; for instance, only distributions that would cause the company's net assets to fall below the subscribed capital or that would exceed available net profits are prohibited.[121]These requirements are particularly relevant to managers of private equity funds; hence, they are known colloquially as the private equity provisions.

Marketing and passporting

The AIFM Regulations implement the AIFMD passporting regime under which authorised EU AIFMs are able to manage and market EU AIFs to professional investors in other Member States without additional authorisation. Guidance on management and marketing passports for UK purposes is set out in the FUND, Supervision (SUP) and PERG sourcebooks in the FCA Handbook. To exercise passport rights, a UK AIFM must meet the conditions set out in Schedule 3 FSMA, including notifying the FCA of its intention to manage or market an AIF in the EU.[122] The availability of the marketing passport was originally expected to be

117 FUND 3.9.
118 FUND 3.3.
119 Regulation 38 AIFM Regulations.
120 Regulation 43(1) AIFM Regulations.
121 Regulation 43(2) AIFM Regulations.
122 See SUP 13.4.

extended to non-EU AIFs, and EU AIFs managed by non-EU AIFMs, in certain jurisdictions in 2015. However, this has since been delayed and it remains to be seen when, and in what form, this may be introduced.[123] If the regime is extended, non-EU AIFMs will have to be authorised by their Member State of reference,[124] and comply fully with the AIFMD, to take advantage of the passport. After 2018, all non-EU AIFMs may be required to be authorised to market in the EU; at this time, the private placement regime discussed below would cease to operate altogether.

Currently, non-EU AIFs and EU AIFs managed by non-EU AIFMs may be marketed to professional investors in the UK under the national private placement regime. To do so, the AIFM must comply with certain requirements, including notification to the FCA and compliance with the transparency requirements and private equity provisions.[125] In practice, this may well mean that marketing within the EU is more difficult than previously. The national private placement regime is not available to EU AIFs managed by EU AIFMs, which can now only be marketed to professional investors in accordance with the AIFMD as described above.

The AIFMD gives Member States discretion to permit the marketing of AIFs to retail investors and to impose greater restrictions than those that apply for marketing to professional investors.[126] However, Member States may not allow an AIF to be marketed to retail investors in their territory unless the AIF is managed in accordance with the AIFMD. No changes have been made to the range of AIFs that may be marketed to the general public in the UK (including NURSs and investment trusts) and domestic rules on the promotion of AIFs to retail investors will continue to apply, but each of these must now be managed by an authorised AIFM.

IV MAIN SOURCES OF INVESTMENT

An estimated £6.8 trillion of funds were under management in the UK at the end of 2014, an increase of 9.7 per cent on the previous year and a sixth successive year of growth.[127] Assets under management increased by between 4 and 5 per cent in the first half of 2015, and it was estimated that this would reach over 9 per cent by year-end. Fund management is estimated to generate around 1 per cent of UK GDP. The UK is the second-largest global fund management centre, after the US, with a share of 6.6 per cent of worldwide conventional funds under management. London is the leading centre for fund management in the UK, but other large fund management centres include Liverpool, Manchester, Edinburgh, Glasgow, Cardiff and Birmingham. Scottish Financial Enterprise estimates that funds managed by the Scottish investment management industry totalled around £800 billion in 2014.

123 See Section V of the European Overview chapter.

124 The Member State of reference should be determined in accordance with Article 37(4) AIFMD.

125 Regulations 57 and 59 AIFM Regulations.

126 Article 43 AIFMD.

127 All figures in this section are taken from TheCityUK, *UK Fund Management 2015*. The estimate of £6.8 trillion total funds under management is believed to be conservative, as it does not take account of those funds for which there are no available estimates, such as certain funds managed on behalf of sovereign wealth funds and private clients.

The UK fund management industry has a strong international orientation: over one-third of funds under management in the UK (around £2.5 trillion) are from overseas. In addition, around 40 per cent of the large and medium-sized asset management firms in London are owned by overseas investors.

Institutional clients provide the majority of funds under management in the UK, contributing around two-thirds of total funds in 2014. Within the institutional investor category, insurance funds contributed £1 trillion, pension funds just under £2.1 trillion and other institutional investors (comprising corporations, local authorities, sovereign wealth funds and charities) over £1.2 trillion.

Retail investors held a record £1.1 trillion in UK-based investment funds in 2014; these consist of UK domiciled funds such as unit trusts, OEICs and investment trusts, and overseas funds managed in the UK (including, e.g., UCITS and exchange-traded funds that are marketed to retail investors). This is around 16 per cent of total funds under management in the UK. Private clients (including private client stockbrokers, and private client departments within banks and asset managers) held assets of around £705 billion, or around 10 per cent of the UK total. Alternative investment funds, including hedge funds, private equity funds, property funds and sovereign wealth funds, contributed £700 billion, which is around 10 per cent of the UK total.[128]

V KEY TRENDS

i Asset allocation

The past 15 years have seen a gradual reduction in the allocation of funds to equity investments, an increase in investment in bonds and generally more diversification of investments. In the institutional investment industry, this trend has been influenced by a range of factors, including changing regulatory requirements, an increasing focus on liability driven investments (see Sections VI.i and ii, *infra*) and a move away from volatile equity markets. At the end of 2015, equity holdings represented 39 per cent of total UK assets under management, which represents a decrease of 1 per cent on the previous year's revised figures.[129] There has also recently been a substantial decline in the holdings of UK equities, which accounted for 60 per cent of total equity holdings in the UK in 2006 but had fallen to around 32 per cent at the end of 2014, although that percentage had increased to around 33 per cent at the end of 2015.[130]

ii Concentration and consolidation

The top five fund managers by UK assets under management accounted for 39 per cent of total funds under management in 2015 (the same figure as of the end of 2014), and the top 10 managers for 56 per cent (an increase of 1 per cent from 2014.[131] Overall, the UK fund management industry remains a highly competitive environment, with considerable change outside these top 10 firms. Of the 10 largest firms, around half are now stand-alone asset management firms, with the other half comprising members of larger insurance or banking

128 As both institutional and private clients invest in these types of funds, these figures have been adjusted for double-counting.

129 IA, *Asset Management in the UK 2015–2016: The Investment Association Annual Survey*, September 2016.

130 Ibid.

131 Ibid.

groups. This reflects a trend over recent years of stand-alone asset managers having increasing significance; in 2003 they accounted for 11 per cent of assets under management in the UK.[132] There was a particularly significant increase from 2008 to 2009, reflecting a wave of divestments by banks as part of their post-2008 restructurings, such as the acquisition of Barclays Global Investors by BlackRock in June 2009.[133] Merger and acquisition activity has continued in the fund management sector, with the strength of activity in recent years continuing. Notable recent large deals involving UK firms include the merger of Standard Life and Aberdeen Asset Management, the acquisition of Flag Capital Management by Aberdeen Asset Management, and the acquisition by Vontobel of a controlling stake in TwentyFour Asset Management.

iii Corporate governance

The UK Stewardship Code (the Stewardship Code) was first published by the Financial Reporting Council (FRC) in July 2010, with the aim of improving the engagement of firms who manage assets on behalf of others with the companies in which they invest. It is directed at institutional investors with equity holdings in UK listed companies, and sets out seven principles covering the monitoring of and engagement with companies on matters such as strategy, performance, risk, remuneration and corporate governance. A new edition of the Stewardship Code has applied from 1 October 2012.

The Stewardship Code is of particular significance to those pension funds that delegate investment management to others; they are expected to satisfy themselves that they have in place a process for monitoring how their asset managers apply the Stewardship Code.[134] They are also expected to ensure that managers are adhering to the fund's stewardship policy, and to seek to hold their managers to account for their stewardship activities.[135]

Since 6 December 2010, UK-authorised asset managers have been required by the FCA to disclose whether they comply with the Stewardship Code. The IA has published the results of its survey on how investment managers have complied with the Stewardship Code for the past five years; as of 30 September 2014, all asset managers and owners surveyed had a public policy statement on how they will discharge their responsibilities under the Stewardship Code.[136]

In June 2011, the government established the Kay Review, which was tasked with reviewing the operation of the UK equity markets and their impact on the long-term performance and governance of UK quoted companies. The final report, published in July 2012, states that asset managers have become the dominant player in the investment chain, and the appointment and monitoring of asset managers is too often based on short-term relative performance.[137] The report recommends that asset managers should contribute more to the performance of businesses through greater involvement in the companies in which they invest, and suggests that the Stewardship Code should be developed to incorporate a more expansive form of stewardship, encompassing strategic issues as well as corporate

132 Ibid., and IA, *Asset Management in the UK 2012–2013: The Investment Association Annual Survey*, August 2013.

133 IA, *Asset Management in the UK 2012–2013: The Investment Association Annual Survey*, August 2013.

134 See NAPF, *UK Stewardship Code: Guidance for Investors*, November 2010.

135 See NAPF, *Stewardship Policy 2012*, November 2012.

136 IA, *Adherence to the FRC's Stewardship Code at 30 September 2014*, June 2015.

137 *The Kay Review of UK Equity Markets and Long-term Decision Making: Final Report*, July 2012.

governance.[138] In line with this recommendation, the revised edition of the Stewardship Code emphasises that stewardship should include matters of company strategy. The report also recommends that all participants in the investment chain, including asset managers, should be subject to fiduciary standards in relation to their clients, which should not be overridden by contractual terms in investment management agreements. In November 2012, the government published its response to the Kay Review, in which it broadly supported Professor Kay's findings and recommendations. In October 2014, the Department for Business, Innovation and Skills reported on the UK's progress in implementing the Kay Review recommendations. It noted that good progress had been made, and that initiatives were in place to encourage effective shareholder engagement and stewardship investment, to improve the quality of reporting and dialogue in the investment chain, and to build trust-based relationships and align incentives through the investment chain. The report also addressed further work that the government is considering to ensure that public equity markets support the long-term success of UK companies.[139]

iv The Retail Distribution Review

In June 2006, the FSA launched a review of retail distribution in the UK (the Retail Distribution Review) with the aim of helping consumers to achieve a fair deal from the financial services industry, and to have confidence in the products they buy and the advice they take.

The rules implementing the outcomes of the Retail Distribution Review came into effect on 31 December 2012, and apply to all advisers in the retail investment market, regardless of the nature of the firm. The new rules aim to improve clarity for investors and reduce the conflicts of interest that previously arose from the remuneration of financial advisers. They prevent commission payments, and require advisory firms to disclose explicitly and charge clients separately for their services. Firms are also required to describe their services clearly as either independent or restricted. In addition, the rules require individual advisers to adhere to consistent professional standards.[140]

v The Fair and Effective Markets Review

In June 2014, the Chancellor of the Exchequer and the Governor of the Bank of England launched a review aimed at reinforcing confidence in the wholesale Fixed Income, Currency and Commodities (FICC) markets (the Fair and Effective Markets Review).

The final report of the Fair and Effective Markets Review was published on 10 June 2015, setting out 21 recommendations to promote fairer FICC market structures while also enhancing effectiveness. A further implementation report was published on 28 July 2016.

The recommendations also include extending the Senior Managers and Certification Regime to cover a wider range of firms that are active in FICC markets. The report notes that this would include: MiFID investment firms, including asset managers and interdealer brokers; hedge funds under the AIFMD; and fund managers under the UCITS Directive. The UK government has implemented this change via the Bank of England and Financial Services Act 2016, which makes provision for the extension of the Senior Managers and Certification

138 Ibid, p. 45.

139 BIS, *Building a Culture of Long-term Equity Investment; Implementation of the Kay Review: Progress Report*, October 2014.

140 COBS 6.1B and 6.2A, and the 'Training and Competence' manual of the FCA Handbook.

regime to all UK authorised firms (including the asset management firms mentioned above). The government has said that it intends that implementation of the newly extended regime should come into operation during 2018.[141] The FCA is currently consulting on proposed updates to the FCA Handbook to implement such changes.[142]

vi The asset management market study

In November 2015, the FCA launched the asset management market study, a review of the asset management sector, with a view to understanding how the retail and institutional asset management sector works for investors.

In November 2016, the FCA published an interim report on the study, which considered price competition in certain areas of the asset management sector, including how managers deliver value for money for retail and institutional clients.

Following consultation on the findings of the interim report, the FCA published its final report on the asset management market study in June 2017. This report was accompanied by a consultation on implementing certain conclusions of the study.[143]

In its final report, the FCA stated that it had concerns about weak price competition in the asset management sector, particularly in relation to active mandates for retail clients, in respect of which it concluded that price competition is not working as effectively as it could be. The FCA also considered whether there is a relationship between fund performance and the level of fees charged by managers, and concluded that both actively managed funds and passive funds – for retail and institutional investors – failed to outperform their own benchmarks once fees were taken into account. Additionally, the regulator noted that it had concerns about how managers communicate investment objectives with their clients, particularly in relation to retail investors. Finally, the FCA voiced concerns about the role of investment consultants and other intermediaries in the asset management sector, particularly in relation to competition among investment consultants.

The FCA proposed certain remedies to the issues it identified in its final report. One of those remedies included proposals to strengthen the duty on asset managers to act in the best interests of their clients, and a proposal for consultations on requiring managers to return certain box profits to their funds and making it easier for managers to switch investors to cheaper share classes. Other measures were aimed at increasing price competition in the asset management sector, including the FCA restating its support of a disclosure of an 'all-in' fee to investors, and the consistent and standardised disclosure of costs and charges to institutional investors. The regulator also stated that it is continuing to consult on whether to make a reference to the Competition and Markets Authority (CMA) to develop the FCA's investigation to date into the investment consultant sector, with a view to taking a final decision in September 2017 – and that, subject to the outcome of a CMA study, it has recommended to HM Treasury that such consultants are brought into the regulatory perimeter.

141 HM Treasury, *Senior Managers and Certification Regime: extension to all FSMA authorised persons*, October 2015.

142 FCA CP17/25, Individual Accountability: Extending the Senior Managers & Certification Regime to all FCA Firms.

143 FCA CP17/18, Consultation on implementing asset management market study remedies and changes to Handbook.

VI SECTORAL REGULATION

i Insurance

The UK insurance industry is the largest in Europe and the third-largest in the world. It contributes significantly to the UK economy, managing investments amounting to 25 per cent of the UK's total net worth.[144] UK insurance funds totalled over £1 trillion in 2014, which represents close to 15 per cent of funds under management in the UK. Around 80 per cent of insurance companies' assets are managed by in-house asset management subsidiaries. The remaining funds are outsourced to third-party asset management firms, although third-party management is increasing.[145]

In terms of asset allocation, the proportion of UK quoted shares held by insurance companies was estimated at 6 per cent at the end of 2014, continuing the fall seen in recent years and the lowest percentage since 1963 (when records began).[146] This decrease reflects a move from investment in equities to bonds and alternative investments, and for greater diversification overseas. This trend is partly attributable to the relative underperformance of stocks. Insurers may also have been pushed to become more cautious by solvency requirements.[147] Asset allocation may be further affected by recent changes to the regulatory regime. In particular, the transposition of the European Solvency II Directive (Solvency II),[148] which came into effect on 1 January 2016, is likely to have an impact on the way in which asset managers invest insurance assets, as certain asset classes will attract higher capital charges than others.

Insurers are dual regulated, in that they are subject to prudential regulation by the PRA and are regulated by the FCA in respect of conduct of business. The investment of insurers' assets is subject to restrictions arising from the prudential regulatory regime for insurers, which in the UK is set out in the PRA Rulebook. The PRA Rulebook reflects, and expands upon, the requirements of various European directives. The Solvency II Regulations[149] were made on 6 March 2015 and made a number of amendments to the FSMA and other primary and secondary legislation. Alongside these changes, the PRA and the FCA have made a number of amendments to their respective rules to reflect the changes required by Solvency II. These amendments came into force on 1 January 2016. In addition, insurers are subject to directly applicable regulations adopted by the European Commission pursuant to Solvency II. These include Delegated Regulation 2015/35 and various implementing technical standards.

The requirements of the relevant European directives have been supplemented and elaborated on in the UK regulatory regime. Aspects of the UK regulatory regime that may affect investments made by insurers include the permitted links regime and requirements that apply to with-profits business.

The permitted links regime

Rule 21.3.1 of the FCA's COBS sourcebook stipulates that insurers are not permitted to provide benefits under linked long-term contracts of insurance that are determined by

144 Association of British Insurers, UK Insurance & Long Term Savings – Key Facts, September 2015.

145 TheCityUK, *UK Fund Management 2015*.

146 Office of National Statistics, *Ownership of UK Quoted Shares 2014*, 2 September 2015.

147 Kate Burgess, 'Big British funds cut UK stocks ownership', *Financial Times*, 12 March 2012.

148 Directive 2009/138/EC.

149 SI 2015/575.

reference to fluctuations in any index that is not an approved index,[150] or by reference to the value of, income from, or fluctuations in the value of, property, other than property that is on the list of permitted links set out in COBS 21.3.1(2). Under Solvency II, the UK has preserved the permitted links regime, but has amended it to meet the Solvency II requirements that it can only apply where the investment risk is borne by a policyholder who is a natural person and that it must not be more restrictive than the regime for CISs under the UCITS Directive. As a result of this, the list of permitted links has been extended to include approved money market instruments. The FCA has indicated that it intends to continue to apply the permitted links regime to trustees of defined contribution pension schemes, where the investment risk is borne by the underlying scheme members. In contrast, under the new regime, insurers are able to link benefits under policies for institutional policyholders (including trustees of defined benefit pension schemes) to any type of asset.

Under the new Solvency II regime, insurers are allowed to use derivatives to cover their technical provisions in respect of linked business without being subject to the requirement that derivatives are held only for the purpose of efficient portfolio management or reduction of investment risks, unless the assets are held in respect of any guarantee of investment performance or other guaranteed benefit provided under the linked long-term contract of insurance.[151] However, any use of derivatives will still need to satisfy the prudent person principle more generally.

With-profits business

A peculiarity of the UK regulatory regime for insurance is the additional layer of requirements for with-profits funds (long-term insurance funds in which policyholders are eligible to participate, broadly, in any excess of assets over the liabilities of the fund). Additional conduct of business rules, set out in COBS 20, apply to the management of these funds, and additional prudential requirements are set out in the With-Profits part of the PRA Rulebook for both Solvency II and Non-Solvency firms. Under Solvency II, additional conduct requirements, but not additional prudential requirements, continue to apply to in-scope firms.

ii Pensions

Occupational pension schemes do not fall within the scope of the MiFID regime and are not CISs under FSMA; however, the investment of fund assets is generally delegated to an external fund manager who is likely to be subject to those regulations. The investment of the assets of occupational pension schemes is, however, subject to restrictions in the Pensions Act 1995 (as amended by the Pensions Act 2004) and the Occupational Pension Schemes (Investment) Regulations 2005 (the Pension Schemes Regulations).

Subject to any restriction in the scheme's trust deed and rules, pension scheme trustees have the power to invest the scheme's assets as if absolutely entitled to those assets and to delegate investment management to a fund manager, provided that manager is either authorised or exempt for the purposes of the general prohibition in the FSMA.[152] Trustees will not be responsible for the acts or default of a fund manager provided they take reasonable steps to satisfy themselves that the manager has appropriate knowledge and experience for

150 Principally an index that is calculated independently, transparently and based on constituents that are permitted links.

151 Investments 5.1 and 5.2 of the PRA Rulebook for Solvency II firms.

152 See Section II.i, *supra*.

managing the investments of the scheme, and carries out his or her work competently and in compliance with provisions governing his or her investment choices.[153] The trustees must ensure that a statement of investment principles (a written statement of the principles governing decisions about investments for the purposes of the scheme) is prepared and revised on a regular basis.[154] The statement must cover various matters, including the trustees' policies in relation to:

a the kinds of investments to be held;
b the balance between different kinds of investments;
c risks, including the ways in which risks are to be measured and managed;
d the expected return on investments;
e the realisation of investments; and
f the extent (if any) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.[155]

Where trustees make investment decisions (rather than delegating to a fund manager), they are also required to obtain and consider proper advice as to whether a particular investment is satisfactory, having regard to the requirements of the Pension Schemes Regulations and the statement of investment principles. If the provision of the investment advice constitutes a regulated activity for the purposes of Section 19 of the FSMA, proper advice must be given by a person entitled to give it (i.e., by an authorised or exempt person).[156]

Regulation 4 of the Pension Schemes Regulations sets out the manner in which the trustees' investment powers in relation to the scheme's assets must be exercised and the restrictions on the assets in which the trustees can invest. The scheme's assets must be invested in the best interests of the members and beneficiaries.[157] Investment powers must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio, and assets must be properly diversified so as to avoid accumulations of risk in the portfolio as a whole.[158] Scheme assets must consist predominantly of investments admitted to trading on regulated markets, and investments in assets that are outside of this category must be kept to a prudent level.[159] In addition, derivative instruments may only be used to the extent that they contribute to a reduction of risks or facilitate efficient portfolio management.[160]

The requirement for scheme assets to consist predominantly of investments admitted to trading on a regulated market does not prevent a pension scheme from holding investments in investment funds as it is permissible to look through investments held in a CIS to the underlying assets.[161] In addition, pension schemes are not restricted from investing in

153 Section 34 Pensions Act 1995.
154 Section 35 Pensions Act 1995 (as amended by the Pensions Act 2004). Regulation 2(1) of the Occupational Pension Schemes (Investment) Regulations 2005 specifies that the statement of investment principles should be reviewed at least once every three years, and in any event following any significant change in investment policy.
155 Regulation 2(3) Occupational Pension Schemes (Investment) Regulations 2005.
156 Section 36 Pensions Act 1995.
157 Regulation 4(2) Occupational Pension Schemes (Investment) Regulations 2005.
158 Regulation 4(3) and (7) Occupational Pension Schemes (Investment) Regulations 2005.
159 Regulation 4(5) and (6) Occupational Pension Schemes (Investment) Regulations 2005.
160 Regulation 4(8) Occupational Pension Schemes (Investment) Regulations 2005.
161 Regulation 4(9)(a) Occupational Pension Schemes (Investment) Regulations 2005.

qualifying insurance policies,[162] such as annuities, which are treated as investments on a regulated market and, to the extent that the assets of a scheme consist of such policies, they are deemed to satisfy the requirement for proper diversification.[163]

There is a further requirement for defined benefit pension schemes in Regulation 4(4), which prescribes that the assets held to cover the scheme's technical provisions (i.e., the value of the scheme's defined benefit liabilities) must be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme.

The major trend in pension fund investment over the past two decades has been a fall in the proportion invested in equities. A number of factors are likely to have contributed to this trend. In addition to the stock market downturn of 2000 to 2003, and the Myners Report of 2001 (which recommended an increased focus on strategic asset allocation), investment strategies have been influenced by the closure of defined benefit schemes to new members and their consequent maturation, and by the introduction of new accounting standards. Many defined benefit schemes, established in the 1950s and 1960s, are now in maturity, and their fund managers have sought to de-risk and pursue more liability-driven investment strategies, where the assets invested in are matched to the fund's liabilities to its members. The FRS17 accounting standard, introduced in 2001 and mandatory from January 2005, states that pension schemes' funding positions must be recognised on company balance sheets, meaning that a company's pension scheme deficit would affect its financial results.[164] FRS102, which is mandatory for accounting periods beginning on or after 1 January 2015, also contains this requirement.[165]

As the number of active members in defined benefit schemes has fallen, contributions to defined contribution (or money purchase) schemes have risen and their importance will continue to increase as they replace the closing defined benefit schemes. During 2012, the government introduced reforms to enrol employees into employee pension schemes automatically, with the ability to opt out, in contrast to the previous system, which enabled employees to opt in to their employer's pension arrangements if any such arrangements were available. This has, according to the Pensions Policy Institute, made a 'phenomenal change to pensions landscape' in the United Kingdom, and could lead to the number of people saving in private sector pension schemes increasing to up to 14.5 million by 2030, with up to £495 billion in defined contribution assets (as against a forecast of 6 million savers and £350 billion in defined contribution assets without automatic enrolment).[166]

Further significant reforms came into force in April 2015, which included removing the requirement for savers with 'money purchase' schemes to purchase an annuity, thereby increasing the flexibility for individuals when they draw their benefits on retirement. New governance requirements for trustees of defined contribution schemes and restrictions on charges in those schemes were also introduced in April 2015. In its 2014 budget, the government announced plans to introduce legislation to allow new pension scheme products

162 As defined in the Occupational Pension Schemes (Investment) Regulations 2005.

163 Regulations 4(9)(b) and 4(10) Occupational Pension Schemes (Investment) Regulations 2005.

164 Office of National Statistics, *Pension Trends*, Chapter 9: 'Pension scheme funding and investment' (2011 edition), 20 April 2011.

165 Section 28: Employee Benefits.

166 Pensions Policy Institute, *Automatic Enrolment Report 3: How will automatic enrolment affect pension saving?*, 17 July 2014.

in the UK based on the 'collective defined contribution' scheme model, in which investment of savers' individual funds is pooled to facilitate the sharing of risk and generate economies of scale. However, the legislation providing for these has not yet come into force.

iii Real property

Background

Traditionally, UK commercial property has often been held through various offshore vehicles, including Jersey property unit trusts, to take advantage of favourable offshore tax treatment. It is also common for investors to hold property through UK listed property companies (in addition to unit trusts) that allow pooling of assets to overcome cost-related barriers to entry into the property market, and to take advantage of a lower rate of stamp duty levied on transactions involving shares than is payable in respect of direct transactions involving real property. However, investing in this manner puts shareholders at a disadvantage when compared with investing directly in property because of the possibility of double taxation.

Real estate investment trusts

Since 2007, it has been possible in the UK to establish real estate investment trusts (REITs), which, like other investment trusts, are listed companies that invest specifically in real estate and that receive advantageous tax treatment. A number of UK-based property companies have converted to REIT status, with the result that the British Property Federation website listed 42 UK REITS as of June 2016.[167] Data published by the Property Industry Alliance (PIA) indicates that in 2014, UK REITs and listed property companies together held commercial property valued at £65 billion.[168]

Following a consultation on possible changes to the rules governing REITs, the government introduced reforms to the REIT regime in the Finance Act 2012.[169] In particular, the former entry charge of 2 per cent of the market value of the properties that are brought within the regime has been abolished, and the requirement that REITs must be listed has been expanded to allow listings on the Alternative Investment Market (AIM) of the London Stock Exchange and other overseas-recognised stock exchanges.

UK REITs are not CISs for the purposes of the definition in Section 235 FSMA; however, they may be AIFs.[170] The FCA has indicated that a REIT is a concept used for tax purposes and so there is no presumption as to whether a REIT is an AIF; this will be considered on a case-by-case basis.[171]

Property authorised investment funds

Since 6 April 2008, it has also been possible to establish a property authorised investment fund (PAIF) in the UK to act as a tax-efficient property investment vehicle.[172] Unlike REITs,

167 www.bpf.org.uk/reits-and-property-companies.

168 PIA, Property Data Report 2015, October 2015.

169 The relevant changes are contained in Schedule 4 of the Finance Act 2012, which amends Part 12 of the Corporation Tax Act 2010.

170 See the discussion of CISs in Section II, *supra*.

171 FSA, CP13/9, *Implementation of the Alternative Investment Fund Managers Directive*, March 2013 and PERG 16.2, question 2.30.

172 The PAIF regime was introduced by the Authorised Investment Funds (Tax) (Amendment) Regulations 2008 (SI 2008/705) adding a new Part 4A to the Authorised Investment Funds (Tax) Regulations 2006 (SI

PAIFs must be structured as OEICs, and there is no requirement for them to be listed on a regulated stock exchange. However, as OEICs they do not benefit from the exemption from the definition of CISs available to other bodies corporate, and must therefore be authorised by the FCA.

To constitute a valid PAIF, the OEIC must carry on a property investment business consisting of one or more of a property rental business, owning shares in UK REITs, or owning shares or units in entities that are equivalent to UK REITs in the jurisdictions in which they are incorporated.[173] In addition, the OEIC must satisfy certain corporate ownership conditions: no body corporate may be directly or indirectly beneficially entitled to 10 per cent of more of the net asset value of the OEIC,[174] and there must be a genuine diversity of ownership, requiring shares in the OEIC to be widely available.[175] There are also requirements that the OEIC must not be a party to any non-standard loan relationship,[176] that a certain percentage of its net income must be from, and a certain percentage of its total assets by value must be used in, its property investment business,[177] and that notice of its status as a PAIF must be given to HM Revenue & Customs (HMRC).[178] Once they come within the ambit of the regime, PAIFs benefit from favourable corporation tax treatment relating to their property investment businesses.

Seeding relief

The Finance Act 2016 introduced a 100 per cent relief from stamp duty land tax when properties are 'seeded' (i.e., initially transferred) into an authorised PAIF or co-ownership ACS.[179]

iv Hedge funds

As hedge funds are typically located in offshore jurisdictions (largely owing to the favourable tax treatment that can be obtained in those territories), there are relatively few UK-based hedge funds. However, London is the second-largest global centre for hedge fund managers (after New York). In practice, the regulation of hedge funds under English law has therefore tended to focus on the managers themselves, rather than the fund entities, which tend to be beyond the UK's jurisdictional reach. All hedge fund managers, like other investment managers, are likely to be undertaking activities that constitute a regulated activity for the purposes of the FSMA and the Regulated Activities Order.[180] As a result, they must have the necessary FCA authorisations to carry out such activities.

Certain funds that invest in underlying hedge funds (funds of funds) may be based in the UK and may be listed on the London Stock Exchange as investment trusts. As discussed

2006/964).

173 Article 69F Authorised Investment Funds (Tax) Regulations 2006.

174 Article 69K Authorised Investment Funds (Tax) Regulations 2006.

175 Article 69J Authorised Investment Funds (Tax) Regulations 2006.

176 Article 69M Authorised Investment Funds (Tax) Regulations 2006.

177 Article 69N Authorised Investment Funds (Tax) Regulations 2006.

178 Article 69O Authorised Investment Funds (Tax) Regulations 2006.

179 Section 65A and Schedule 7A Finance Act 2003.

180 For example, such managers are likely to be managing investments under Article 37 of the Regulated Activities Order, advising on investments under Article 53 of the Regulated Activities Order or managing an AIF under Article 51ZC of the Regulated Activities Order.

earlier, investment trusts are not CISs for the purposes of the FSMA and do not therefore require FCA authorisation themselves. Nonetheless, the investment manager of an investment trust will still need to be authorised. The advantage of a UK-listed fund of funds is that it can provide an indirect route to investment in multiple underlying hedge funds while still requiring adherence to the continuing obligations and reporting requirements contained in the UK Listing Authority's Listing Rules.

In the past, the FSA took the view that hedge fund managers, by virtue of managing offshore funds, have a low impact on the UK financial markets and represent little risk to UK retail investors.[181] The FSA therefore made a conscious decision not to allocate a large amount of its supervisory resources to hedge fund managers. However, in recent years the FCA (and previously the FSA) has become increasingly interested in the activities of hedge funds, and the ongoing financial crisis has generated discussion of the potential systemic risks posed by such funds, particularly as counterparties to trades with financial institutions and others within the financial markets.[182] The risks associated with hedge funds are reviewed on an ongoing basis, and the FCA has significantly increased its scrutiny of the hedge fund industry, including through enforcement action taken against hedge fund managers and their staff.

UK regulation of hedge funds is also led by the overarching provisions introduced by EU legislation such as the AIFMD. There has been recent growth in the number of UCITS-compliant hedge funds,[183] the managers of which will not be required to comply with the AIFMD but will nevertheless likely require FCA authorisation for carrying out regulated activities as described above.[184] Non-UCITS hedge funds are likely to fall within the definition of AIFs; the managers of such funds, as AIFMs, are subject to the requirements of the new regime.

In 2008 the Hedge Fund Standards Board (HFSB) was established to act as an industry body to represent hedge funds and to improve standards across the hedge fund industry. The HFSB publishes the Hedge Fund Standards, which are designed to encourage greater transparency and more effective governance across the hedge fund sector in an attempt to pre-empt the requirement for greater regulation and legislative intervention.[185] Funds that adopt the Hedge Fund Standards are required to adhere to a comply or explain regime, ensuring that certain information is disclosed to investors about how the standards have been complied with, or why certain requirements have otherwise not been met or are not appropriate in the context of a particular fund. As of May 2015, 123 hedge fund managers with combined assets under management of over US$700 billion had committed to the Hedge Fund Standards.[186]

v Private equity

In the UK, private equity firms typically use limited partnerships as investment vehicles to take advantage of their tax-transparent nature and their lower disclosure requirements as compared with limited companies or LLPs. The limited partners in the partnership are

181 FSA, *Hedge funds and the FSA* at Paragraph 4.24, August 2002.

182 See, for example, FSA, 'Accessing the possible sources of systemic risk from hedge funds – a report on the findings of the FSA's Hedge Fund Survey and Hedge Fund as Counterparty Survey,' February 2012.

183 The CityUK, *Hedge Funds*, May 2013.

184 Ibid.

185 The HFSB, *The Hedge Fund Standards* (11/2015), 5 November 2015.

186 The HFSB, *Annual Report* 2014.

typically the institutional investors in the private equity fund, while the private equity firm will usually act as the general partner and will therefore be responsible for the day-to-day management of the partnership's activities.

The UK is the largest and most developed private equity centre in Europe, second in size globally only to the US.[187] Fundraising in the private equity sphere has improved significantly in recent years, with 2015 being the third consecutive year in which private capital fundraising surpassed the US$500 billion mark.[188] Preqin, the alternative investment industry analyst, predicted in January 2016 that fundraising should remain strong through the coming year due to investor appetite, although it noted that there are ongoing challenges for investors in identifying the best investment opportunities in an increasingly competitive market.[189] It remains to be seen whether the result of the UK referendum on membership of the EU will have a significant impact on private equity fundraising or investment in the UK in the near term.

There have been some initiatives in recent years to improve the transparency of the private equity industry in the UK in order to address criticism that the activities of private equity funds are opaque and to counteract the perception that they are insufficiently regulated. In November 2007, the Walker Guidelines were introduced to encourage improved disclosure by private equity bodies.[190] These voluntary guidelines recommend that private equity firms that meet certain specified criteria[191] should publish annual reviews or regular updates on their website containing information about their investment approaches and portfolios. In addition, the guidelines state that private equity firms should provide various performance data on a confidential basis to an independent third party appointed by the British Private Equity and Venture Capital Association (BVCA) in an effort to encourage increased transparency about the overall private equity industry. As a result of a consultation by the Walker Guidelines Monitoring Group, the Walker Guidelines were amended in July 2014 to enhance the reporting requirements therein to include the information required by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.

In September 2009, the Institutional Limited Partners Association (ILPA) published its first set of private equity principles with the aim of encouraging improvements in private equity practice by furthering the relationship between general partners and limited partners for the long-term benefit of participants in the industry. A revised set of principles was

187 TheCityUK, *UK Fund Management 2015*.

188 Preqin, *The 2016 Preqin Global Private Equity and Venture Capital Report*, January 2016.

189 Ibid.

190 Sir David Walker, *Guidelines for Disclosure and Transparency in Private Equity*, November 2007.

191 Under the Guidelines, a private equity firm is defined as 'a firm authorised by the FSA that is managing or advising funds that either own or control one or more UK companies or have a designated capability to engage in such investment activity in the future where the company or companies are covered by the enhanced reporting guidelines for portfolio companies'. In turn, a portfolio company is defined as 'A UK company (a) acquired by one or more private equity firms in a public to private transaction where the market capitalisation together with the premium for acquisition of control was in excess of £300 million, more than 50 per cent of revenues were generated in the UK and UK employees totalled in excess of 1,000 full-time equivalents; [or] (b) acquired by one or more private equity firms in a secondary or other non-market transaction where enterprise value at the time of the transaction is in excess of £500 million, more than 50 per cent of revenues were generated in the UK and UK employees totalled in excess of 1,000 full-time equivalents'.

subsequently released in January 2011 following feedback from industry participants.[192] The ILPA principles encourage a greater focus on transparency, governance, and the alignment of interests between private equity managers and their investors.

Traditionally, private equity has been a relatively lightly regulated area of asset management in the UK although, in common with other asset management entities, private equity firms have required FCA authorisation if they are undertaking regulated activities specified in the Regulated Activities Order. This relatively relaxed treatment has changed, however, following the implementation of the AIFMD, as managers of private equity funds fall within the scope of the new regime. The private equity industry has voiced concerns over the potential impact of the AIFMD on private equity activities.[193] The rules on remuneration are likely to have an impact on policies at private equity firms, particularly in relation to the requirements for deferred remuneration. Furthermore, the private equity provisions (intended to limit asset-stripping of companies) may interfere with some of the usual funding structures adopted by private equity funds, potentially restricting corporate reorganisations and targeted disposals of parts of a target company's business.

Managers of certain venture capital funds may benefit from the European Venture Capital Funds Regulation (the VCF Regulation).[194] The VCF Regulation applies to managers of collective investment undertakings (other than UCITS schemes) that are established in the EU, are registered in their home Member State in accordance with the AIFMD and manage portfolios of qualifying venture capital funds. Generally, the VCF Regulation applies to managers of collective investment undertakings with assets under management that do not exceed €500 million in total. Such managers may use the European venture capital fund designation if they meet a number of conditions. The VCF Regulation introduces a marketing passport, which can be used to market funds with European venture capital status to EU investors, subject to complying with certain requirements. This allows managers of qualifying funds to benefit from cross-border marketing without having to comply with the full requirements of the AIFMD.

vi Other sectors

Sovereign wealth funds

While the UK does not operate an SWF of its own, London remains a popular location for foreign sovereign wealth funds (SWFs) to establish branches to pursue their investment activities, and the government has generally sought to encourage foreign direct investment into the UK. Continuing on from a period of sustained growth in SWF investment in the UK during the economic downturn, the assets under management of SWFs increased by 16 per cent in 2014 to a record US$7.1 trillion. This figure was forecasted to increase by another 4 per cent in 2015.[195]

There is no specific regulatory regime that applies to foreign investment by SWFs in the UK; instead, the position is regulated by general provisions in domestic and EU law

192 ILPA, Private Equity Principles, version 2.0, January 2011, available at ilpa.org/ilpa-private-equity-principles.

193 See, for example, the statement by Simon Walker, Chief Executive of the BVCA, on the AIFMD on 26 October 2010, in which he referred to the AIFMD as a 'defective Directive' and argued that the EU had taken a 'hostile interest in the wrong industry at the wrong time and for the wrong reasons'.

194 Regulation 345/2013.

195 TheCityUK, *Sovereign Wealth Funds 2015*.

that may permit review of proposed transactions in certain defined circumstances that are of general application. For example, an acquisition of UK assets is always liable to review under the merger control regimes established under the Enterprise Act 2002 or by the EC Merger Regulation[196] if there are concerns that the transaction would result in a significant reduction in competition in a particular market. It is also possible for the government to intervene in certain circumstances where the investment involves issues of special public interest – for example, where a transaction might have an adverse effect on media plurality by concentrating control of the supply of newspapers or provision of broadcasting.[197] Subject to the range of specific requirements, however, there is no other overriding rule that requires approval for foreign direct investment in the UK.

Exchange-traded funds

Exchange-traded funds (ETFs) are passively managed open-ended funds that are listed and traded on a stock exchange. The fund's trading price is linked to the net asset value of the underlying assets and typically tracks the performance of an index, such as the FTSE 100. The key characteristics of an ETF are that it is tradeable and that it offers simple exposure to a more complex underlying asset or index. ETFs are popular with investors as they have lower operating expenses than actively managed funds and a transparent structure (as a listed company), and are tax-efficient. In the UK, ETFs are OEICs.

ETFs have performed well in recent years, venturing into emerging markets, real estate, infrastructure, private equity and hedge funds, such that the assets under management of ETFs grew to a record high of US$3 trillion in 2014.[198] Following a Federation of Small Businesses report on ETFs in April 2011, which highlighted the potential risks of the rapid increase in value of the ETF industry, European regulators have begun to focus attention on these structures. ESMA published revised consolidated guidelines on ETFs and other UCITS-related issues in August 2014, and an updated questions and answers paper on ETFs and other UCITS-related issues in February 2016. The FCA has incorporated ESMA's guidelines into the COLL sourcebook.

Venture capital trusts

The venture capital trusts (VCTs) scheme was introduced in the UK in April 1995 as a means of encouraging individual investors to support higher-risk unlisted start-up companies. VCTs, like investment trusts, are not trusts, but rather are companies that are listed on a regulated market in the EU. They invest in securities issued by small unquoted[199] trading companies for which there is no liquid market. VCTs help mitigate this investment risk for investors by spreading their investments across a range of such companies, and by providing liquidity through the VCT's own listed shares to overcome the illiquidity of its underlying assets.

In order to be treated as a VCT, a company must be approved as such by HMRC.[200] Such approval will be granted only if the company satisfies certain specified statutory conditions, which include requirements that the VCT's income must derive wholly or mainly from

196 Regulation 139/2004.

197 Section 59 Enterprise Act 2002.

198 TheCityUK, *UK Fund Management 2015*.

199 In Section VCM55180 of the HMRC Venture Capital Schemes Manual, HMRC indicates that shares listed on the AIM market are regarded as unquoted for the purposes of the VCT regime.

200 Section 259 Income Tax Act 2007.

shares or securities; that it must invest most of its assets in certain qualifying investments in companies that meet certain criteria as to their size and independence; and that the ordinary shares of the VCT must be listed on a regulated market in the EU.[201]

Favourable income and capital gains tax reliefs are available to individuals who invest in VCTs, including an exemption from tax on dividends from ordinary shares in VCTs and relief from gains made on disposals of such shares. The VCT is itself exempt from corporation tax on chargeable gains on the disposal of its investments.[202] If a VCT ceases to satisfy the required conditions for an accounting period, HMRC may withdraw its approval and investors will lose this favourable tax treatment.[203]

The VCT scheme has recently undergone significant change, most notably the increase in the number of conditions a company must meet in order to be approved as a VCT. For example, the Finance (No. 3) Act 2010 introduced a requirement that investee companies of VCTs must have a UK permanent establishment while the VCT holds the investment and must not be 'in difficulty' when the shares held by the VCT are issued.[204] Schedule 8 of the Finance Act 2012 increased the maximum permitted size of investees and added a disqualifying arrangements condition, whereby certain artificial arrangements that are designed to take advantage of VCT reliefs will be excluded from the regime. In addition, the Finance Act 2014 introduced certain measures restricting the ability of VCTs to return share capital to investors and the availability of income tax relief where subscriptions are effectively 'recycled'.

For investments made on or after 18 November 2015, the Finance (No. 2) Act 2015 added further approval conditions for VCTs – generally, that VCTs must not make investments in companies that breach a permitted maximum age limit or a prohibition on business acquisitions. The Finance Act 2016 added a condition that prevents companies from making certain investments. It also excludes all energy generation activities, including the production of gas or other fuel, from the VCT scheme , which had effect from 6 April 2016.[205]

VII TAX LAW

i Taxation at the level of the investment vehicle

Taxation at the fund level is determined by the fund type. In certain cases (e.g., AUTs and OEICs, which for tax purposes are referred to collectively as authorised investment funds, exempt UUTs, investment trusts, VCTs and REITs), the relevant tax treatment will apply only if certain statutory criteria are met.

A summary of the usual tax treatment of each of the main types of investment vehicle is set out below.

201 Section 274 Income Tax Act 2007; Regulation 3 Venture Capital Trust Regulations 1995.

202 Section 100 Taxation of Chargeable Gains Act 1992.

203 Further guidance on HMRC's interpretation of the VCT regime is available in the HMRC Venture Capital Schemes Manual.

204 HMRC has provided limited guidance on the interpretation of the phrase 'in difficulty' by reference to relevant guidelines on the EU state aid rules. See Section VCM55050 of the HMRC Venture Capital Schemes Manual, which reproduces guidance provided in the European Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty (2004/C244/02).

205 Section 303(1) Income Tax Act 2007 (as amended by Section 28 Finance Act 2016).

Taxation of UK-resident investment funds

Type of vehicle	Taxation of income	Taxation of realised gains
Investment trust	Dividend income generally exempt Non-dividend income generally taxable at 20% Management expenses deductible Distributions of interest income deductible if election made	Exempt
Authorised investment funds (OEIC/AUT)	Dividend income generally exempt Non-dividend income generally taxable at 20% Management expenses deductible Distributions of interest income deductible if more than 60% of holdings are debt instruments (or similar investments)	Exempt
REIT	Income from real estate investment exempt Dividend income generally exempt All other income taxable at 19%	Gains from real estate investments exempt Gains from other investments taxable at 19%
Exempt UUT	Income taxed at 20% but all income deemed to be distributed annually and that distribution treated as deductible, so typically no tax is payable	Exempt
Non-exempt UUT	Non-dividend income taxed at 19% (with no deduction for distributions to investors or for management expenses)	Gains taxed at 19%
VCTs	Dividend income generally exempt Non-dividend income generally taxable at 19% Management expenses deductible	Exempt
Authorised contractual scheme	Fiscally transparent	Fiscally transparent (except that, for capital gains purposes, investors in co-ownership schemes are treated as owning interests in the scheme)
Limited partnership	Fiscally transparent	Fiscally transparent
Limited liability partnership	Fiscally transparent	Fiscally transparent

The above summary assumes that the relevant vehicle is resident in the UK for UK tax purposes. Where an investment vehicle invests in UK assets but is not resident in the UK, it will only be subject to tax in the UK, to the extent that (1) its investments comprise UK land or are subject to UK tax at source or (2) it is trading in the UK.

While non-resident investment managers are chargeable to UK tax in respect of income from a trade conducted in the UK, UK tax law does recognise the distinction between managing investments and trading in assets, and the UK activities of investment managers are generally protected (investment in UK land being a notable exception). A non-UK resident company will not be taken to be trading in the UK (and thus subject to tax in the UK) simply by virtue of employing the services of an independent UK investment manager, provided that certain conditions (as to the manager's activities, relationship with the non-resident company and remuneration and as to the nature of the assets) are met.[206]

ii Taxation at the level of the investor

A summary of taxation at source of fund distributions and the application of stamp taxes is set out below.

206 Sections 1142 and 1146 Corporation Tax Act 2010. See also HMRC Statement of Practice I (2001) (as amended).

Stamp taxes may not apply if the relevant vehicle is not incorporated in the UK and no register of interests in the vehicle is maintained in the UK.

Taxation of investors in domestic funds

Type of vehicle	Taxation of income	Taxation of realised gains
Investment trust	No deduction at source*	Payable on transfers of shares
Authorised investment fund (OEIC/AUT)	No deduction at source**	Generally exempt
REIT	Subject to deduction at source at 20%, unless an exemption applies (e.g., payment to UK companies) or treaty relief is available	Payable on transfers of shares
UUT (exempt or non-exempt)	No deduction at source	Generally exempt
Authorised contractual scheme	Fiscally transparent	Generally exempt
Limited partnership	Fiscally transparent	Payable on transfers of partnership interest only if partnership assets include shares (or certain other marketable securities) or land
Limited liability partnership	Fiscally transparent	As for limited partnerships

* Interest distributions made before 6 April 2017 were subject to withholding on account of income tax unless certain exemptions applied. This is no longer the case for interest distributions made on or after 6 April 2017 pursuant to Section 888B Income Tax Act 2007 (which was inserted by Schedule 5, Finance Act 2017).

** Interest distributions made before 6 April 2017 were subject to withholding on account of income tax unless certain exemptions applied. This is no longer the case for interest distributions made on or after 6 April 2017 pursuant to Sections 888C and 888D Income Tax Act 2007 (which was inserted by Schedule 5, Finance Act 2017).

iii Anti-avoidance rules

Anti-avoidance rules exist to prevent UK-resident companies and individuals rolling up income in an offshore fund and effectively converting it into chargeable gains. The rules target arrangements under which participants enjoy benefits from the holding, management or disposal of assets without having day-to-day control over their management, and can expect to obtain a return based on the fund's net asset value or on the value of an index.

The UK also has a regime for the effective taxation of controlled foreign companies. Where a UK company holds an interest in a foreign investment company and that foreign company's profits are taxed at less than 75 per cent of the UK rate, all or part of its profits may be allocated to the UK investor depending on, *inter alia*, the extent of the investor's interest in the company.

The UK also has rules that can operate to tax income arising to an offshore vehicle in the hands of an individual in certain circumstances.

iv Recent and proposed developments

Carried interest

The Finance Act 2015 inserted a new Chapter 5E into Part 13, Income Tax Act 2007 with the aim of ensuring that an investment manager's management fees are subject to income tax, rather than being converted into capital receipts.

ACS and partnerships

A number of pieces of draft legislation have been put forward by the government in relation to streamlining the tax rules and reporting requirements for authorised contractual schemes (e.g., the Collective Investment Schemes and Offshore Fund Regulations 2017 and the Co-ownership Authorised Contractual Schemes (Tax) Regulations 2017).

The government also recently conducted a consultation on the tax treatment of partnerships and LLPs and their partners. A summary of responses to the consultation was published in March 2017, in which it was announced that the government intends to introduce legislation for the 2018–2019 tax year. The government has stated that the proposed legislation will seek to remove uncertainty and provide clarity for partnerships. The measures will require greater transparency as to the persons ultimately entitled to the profits of partnerships and the basis on which such persons will be taxed on those profits.

Base erosion and profit shifting

The UK has adopted a proposal put forward by the Organisation for Economic Co-operation Development as part of the base erosion and profit shifting (BEPS) project including the adoption of detailed rules aimed at certain hybrid mismatch arrangements, which had effect from 1 January 2017. Such measures clearly have the ability to impact the tax treatment of funding structures commonly used by private equity and hedge funds in particular.

The Finance Bill (No. 2) 2017 is expected to include measures implementing another BEPS proposal that will limit the extent to which interest expenses can be used to reduce a company or group's corporation tax liability from 1 April 2017. It is expected that distributions of interest by investment trusts and authorised investment funds will be outside the scope of the proposals; however, it does not appear that there will be any further specific rules for AIFs or investment trusts under the regime.

VIII OUTLOOK

Notwithstanding the result of the UK's referendum on membership of the EU, it remains subject to EU law until its exit process is complete, which is not expected to take place until at least March 2019. Consequently, new EU regulatory developments continue to dominate the short- to medium-term outlook in the UK asset management sector.

i MiFID II and MiFIR

The key forthcoming regulatory development, which will have a significant effect on asset managers, is the reform of the existing MiFID regime. The new MiFID II and MiFIR rules will have an impact on non-UCITS investment management services in the EU.[207] Among other things, UK investment firms will find themselves subject to more onerous conduct of business, corporate governance requirements and transaction reporting requirements than those currently in place.

The MiFID II Directive and MiFIR were published in the Official Journal on 12 June 2014 and were intended to be applied from 3 January 2017, although this has since been delayed until January 2018 due to challenges with implementation.

207 See Section IV.x of the European Overview chapter.

ii Market Abuse Regulation

In July 2016 the new European Market Abuse Regulation (MAR) came into force. The new regulation, which introduces a directly applicable regime for market abuse across the EU, is designed to complement the revised MiFID II regime and to create a stronger and more uniform framework in order to preserve market integrity.

Key changes that will be relevant for asset managers include:

a a broadening of the definitions of inside information and market manipulation (in particular to capture certain high frequency and algorithmic trading activities);

b an extension of the requirements on identification and reporting of suspicious transactions; and

c more stringent requirements regarding the dissemination of investment recommendations.

Certain aspects of MAR that relate to new concepts introduced under MiFID II (such as organised trading facilities (OTFs)) will not apply until MiFID II comes come into force, which as mentioned above is currently due to take place in January 2018. In addition, certain ESMA guidelines are yet to be finalised.

iii Regulatory scrutiny

In its Business Plan for 2016–2017, the FCA identified certain priority themes, one of which was advice (focusing in particular on implementing the recommendations arising from the FAMR, discussed above).[208] The other themes that are of particular significance to the asset management industry were:

a pensions (including the impact and implications of the recently introduced pensions freedoms, as well as work on annuities markets); and

b wholesale financial markets (focusing on implementation of the new market abuse and MiFID regimes and the Fair and Effective Markets Review).

208 See Section II.ii *supra*.

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