

THE ASSET  
MANAGEMENT  
REVIEW

EIGHTH EDITION

Editor  
Paul Dickson

THE LAWREVIEWS

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REVIEW

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This article was first published in September 2019  
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Published in the United Kingdom  
by Law Business Research Ltd, London  
Meridian House, 34-35 Farringdon Street, London, EC4A 4HL, UK  
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ISBN 978-1-83862-057-8

Printed in Great Britain by  
Encompass Print Solutions, Derbyshire  
Tel: 0844 2480 112

# ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ABOU JAOUDE & ASSOCIATES LAW FIRM

ADVOKATFIRMAET BAHR AS

ALLEN & GLEDHILL LLP

ALLEN & OVERY LLP

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URÍA MENÉNDEZ

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# PREFACE

Despite significant improvements in the global economic landscape in the years since the global financial crisis some ten years ago, the macroeconomic position is looking increasingly complex and global growth has been hampered by various geopolitical factors, including political uncertainty and the rise of populist movements in Europe. As the UK prepares for Brexit, absent any agreement to the contrary currently set to take place at the end of October 2019, political uncertainty remains around the form and extent of any UK–EU deal relating to financial services, and as to whether any transition period (during which UK firms would remain able to access to EU markets on current terms) will be agreed. This has had, and is likely to continue to have, a potentially destabilising effect on the UK asset management sector and its clients. The impact of the UK’s decision to leave the EU is thus already being felt, not only in the UK and across the European continent, but also more widely.

Nevertheless, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. Both industry bodies and legislators are also increasingly interested in pursuing environmental, social and governance (ESG) goals through private sector finance. For example, the European Commission has proposed a package of measures seeking to introduce sustainable finance into current regulations to make it easier for investors to identify and invest in such projects.

This should not be a surprise: lack of shareholder engagement has been identified as one of the key issues contributing to the governance shortcomings during the financial crisis. Given the importance of the asset management industry in investing vast amounts on behalf of clients, the sector is the natural focus of regulatory and governmental initiatives to promote effective stewardship and take the lead in instilling a corporate cultural focus on sustainability and ESG initiatives.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. In Europe, further significant changes to the regulatory landscape for investment services were introduced by the revised Markets in Financial Instruments Directive regime (known as MiFID II), which has applied since 3 January 2018. In the UK, the Financial Conduct Authority continues to focus on the asset management industry. In 2017, it published its asset management market study on the performance of the asset management market for retail and institutional investors, and is beginning to implement its findings during the course of 2018. In contrast, the Trump administration in the US has signalled a deregulatory agenda, which includes plans to

repeal the Wall Street Reform and Consumer Protection Act of 2010 (also known as the Dodd-Frank Act).

It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis: the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing their funds. Senior managers at investment firms are, through changes to regulatory requirements and expectations as to firm culture, increasingly being seen as individually accountable within their spheres of responsibility. Industry bodies have also noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. This may, in itself, be storing up issues for years to come.

The rise of fintech and other technological developments, including cryptocurrencies, data analytics and automated (or ‘robo’) advice services, is also starting to have an impact on the sector, with asset managers looking to invest in new technologies, seeking strategies to minimise disruption by new entrants, or both. While regulators are open to the development of fintech in the asset management sector, they also want to ensure that consumers do not suffer harm as a consequence of innovations. Regulators across various jurisdictions are working together to develop a global sandbox in which firms can test their new technologies.

This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements, and adapt to the changing geopolitical landscape. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself and the global value of assets under management continues to increase year on year. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the eighth edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank the team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that this edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

**Paul Dickson**

Slaughter and May

London

August 2019

# UNITED KINGDOM

*Paul Dickson*<sup>1</sup>

## I OVERVIEW OF RECENT ACTIVITY

The regulatory landscape for asset management continues to 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. Recent large-scale reforms have been, to a large extent, driven by European initiatives, with many new measures originating at EU level; for instance, revisions to the Alternative Investment Fund Managers Directive (AIFMD) and the UCITS IV Directive (UCITS Directive) as part of the EU's implementation of its capital markets union initiative, the revision of the markets in financial instruments regime (MiFID II), and the preparation of a revised EU prudential framework for investment firms.<sup>2</sup> 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, with notable recent supervisory activity including its Asset Management Market Study. Meanwhile, overlaying this all, the impact of Brexit looms large.

The view of the Investment Association (IA)<sup>3</sup> 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. At present, the FCA notes that nearly £8 trillion assets are managed in the UK,<sup>4</sup> and the UK's asset management industry is the largest in Europe, managing funds of both UK-domiciled and overseas investors. In fact, the UK accounts for around 35 per cent of all European assets under management.<sup>5</sup> The IA has stated that the UK's place as a pre-eminent centre of asset management has been undisputed for a number of years, but warns that this is

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1 Paul Dickson is a partner at Slaughter and May. The author would like to thank Tamara Raoufi, Tanja Velling and Anders Jay for their assistance in preparing this chapter.

2 See Section VII of the European Overview chapter.

3 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.

4 Towards more effective stewardship, speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA, 3 April 2019.

5 Asset management: A regulatory perspective, speech by Andrew Bailey, Chief Executive of the FCA, 26 April 2018.

by no means guaranteed in the future. It points to Brexit as raising several challenges to the asset management industry, in particular in relation to fund passporting, maintaining access to skilled personnel and the transfer of data.<sup>6</sup>

## 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.<sup>7</sup> Regulated activities are specified activities set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (Regulated Activities Order)<sup>8</sup> that are carried on by way of business in connection with certain specified investments also listed in the Regulated Activities Order.<sup>9</sup> 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);<sup>10</sup> 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

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6 The IA, Asset Management in the UK 2017-2018, The Investment Association Annual Survey, September 2018.

7 Section 19 FSMA.

8 SI 2001/544.

9 Section 22 FSMA.

10 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.

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.<sup>11</sup>

### **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.<sup>12</sup> 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 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.<sup>13</sup>

### **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.*<sup>14</sup>

Participants in a CIS must not have day-to-day control over the management of the property.<sup>15</sup> 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,<sup>16</sup> or both.<sup>17</sup> 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 (Collective Investment Schemes Order),<sup>18</sup> which excludes, among other arrangements, all bodies corporate (other than open-ended investment companies (OEICs) and limited liability

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11 Section 23(1)(b) FSMA.

12 Section 21(1) FSMA.

13 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).

14 Section 235(1) FSMA.

15 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.

16 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.

17 Section 235(3) FSMA.

18 SI 2001/1062.

partnerships), contracts of insurance, and occupational and personal pension schemes.<sup>19</sup> 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 are specified activities under the FSMA that require FCA authorisation.<sup>20</sup> 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, except in certain circumstances (e.g., where the promotion is made only to investment professionals).<sup>21</sup> The promotion of unregulated CISs, together with certain close substitutes called non-mainstream pooled investments, is prohibited to the majority of retail investors.<sup>22</sup>

## 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.<sup>23</sup> 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-

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

20 Articles 81 and 51ZE Regulated Activities Order.

21 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).

22 COBS 4.12.

23 The FCA Handbook is available at [www.handbook.fca.org.uk/handbook](http://www.handbook.fca.org.uk/handbook).

business requirements that apply to authorised investment firms.<sup>24</sup> The FCA substantially updated the FCA Handbook to reflect the MiFID II regime, which came into force in January 2018.

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.<sup>25</sup> Notably, the FCA recently published the final report on its wide-ranging asset management 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 (see further details in Section V.vi, below).

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 the 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 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. It launched a call for input asking for feedback on its proposed approach to reviewing the outcomes of the FAMR in May 2019, with the publication of the review findings currently expected in autumn 2020.

Another key area of interest for the FCA over the past few years has been potential conflicts of interest between asset management firms and their clients, particularly in relation to the clarity of fund charges, inducements given or received by investment firms, and the way in which commissions charged to customers were spent. Prior to the implementation of MiFID II, the FCA had reformed its rules on the use of dealing commission to make clear that commissions should only be spent on the actual costs of executing customer orders, goods and services related to the execution of trades, or goods and services related to the provision of research. Under the new MiFID II inducements regime however, many asset managers are now prevented from charging clients for research on a bundled basis, and must either pay for the research directly from their own balance sheets or charge the costs back to clients via a special research payment account.<sup>26</sup> The FCA has reviewed how asset managers are implementing these rules and how firms are pricing research and corporate access services. The review concluded that while most asset managers calculated transaction costs in accordance with the new rules, there are problems with the way some asset managers are calculating transaction costs and how they disclose them. Further, the FCA has been

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24 See Section III of the European Overview chapter.

25 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 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.

26 See Section III of the European Overview chapter.

expanding its interest in innovation, big data, technology and competition. The FCA has set fintech as one of its cross-sector priorities, particularly noting that it is driving change in markets and encouraging innovations. The FCA has launched programmes to enable the development of fintech, for example, by providing assistance to firms using innovation to improve consumer outcomes through its Innovate programme. Firms can test the commercial and regulatory viability of their innovative concepts before investing in them in the FCA's regulatory 'sandbox'. In the context of asset management specifically, the FCA launched its Advice Unit to provide regulatory feedback to firms developing automated models to deliver lower-cost advice and guidance to consumers, and on 21 May 2018 published guidance in relation to automated investment services,<sup>27</sup> and specifically its approach to the supervision of automated or 'robo' advice.<sup>28</sup> In a review of the impact and effectiveness of its innovation programme, published in April 2019, the FCA noted that asset management was one of the sectors from which it had received comparatively low numbers of applications for the regulatory sandbox, despite proactive attempts to engage with the sector.<sup>29</sup>

The FCA issued its first decision under competition law in February 2019, penalising three asset managers found to have shared strategic information in relation to initial public offerings and one placing. The FCA issued fines of £306,300 and £108,600 (one of the asset managers was given immunity under the competition leniency programme), and it was widely regarded as the start of a crackdown on information sharing in equity capital markets transactions. The FCA also recently published a package of measures to improve competition in the investment platforms market.<sup>30</sup> The measures include provisions designed to allow consumers to switch platforms and remain in the same fund without having to sell their investments, together with restrictions on exit fees.

### 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.

#### i Open-ended investment vehicles

Open-ended funds issue and redeem securities to and from investors in a 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.

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27 FCA, Automated investment services – our expectations, 21 May 2018. See also Finalised Guidance FG 17/8, Streamlined advice and related consolidated guidance, September 2017.

28 FCA, Robo Advice: an FCA perspective, 2 November 2017.

29 FCA, The Impact of Effectiveness of Innovate, April 2019.

30 FCA, Market Study MS17/1.3 – Investment Platforms Market Study Final Report, March 2019.

### ***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<sup>31</sup>). 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.<sup>32</sup> 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.<sup>33</sup> Secondly, AUTs are not liable to pay UK tax on the chargeable gains realised on a disposal of assets in their underlying investment portfolios.<sup>34</sup>

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 it does not benefit from the exemption on 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 their 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.

### ***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.<sup>35</sup> In many ways, OEICs are similar to AUTs (the statutory and regulatory provisions applying to

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31 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.

32 Section 237(3) FSMA.

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

34 Section 100 Taxation of the Chargeable Gains Act 1992.

35 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

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<sup>36</sup>). Therefore, 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.<sup>37</sup> 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,<sup>38</sup> and the current regulatory framework operates through two distinct sets of regulations: the Open-Ended Investment Companies Regulations 2001 (OEIC Regulations),<sup>39</sup> 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.<sup>40</sup> 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.<sup>41</sup> As with AUTs, OEICs must also permit shareholders to have their shares redeemed or repurchased 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.<sup>42</sup> Alternatively, or in addition, shareholders must be entitled to sell their shares on

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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.

36 Regulation 5 OEIC Regulations.

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

38 Section 262 FSMA.

39 SI 2001/1228.

40 Regulation 3(1) OEIC Regulations.

41 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)).

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

an investment exchange at a price that is not significantly different from the redemption or repurchase price.<sup>43</sup> UK OEICs are not subject to the restriction on the promotion of CISs contained in Section 238 FSMA.<sup>44</sup>

### ***Authorised contractual schemes***

The Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013 (Contractual Scheme Regulations) came into force on 6 June 2013.<sup>45</sup> 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 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.<sup>46</sup> An ACS is defined in the FSMA as a contractual scheme that is authorised in accordance with Section 261D(1) FSMA.<sup>47</sup> The FCA may authorise a contractual scheme if it is satisfied that the scheme complies with the requirements of Sections 261D and 261E FSMA; the scheme meets the requirements of the contractual scheme rules (set out in COLL); and 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.<sup>48</sup>

The general restriction on the promotion of CISs does not apply to ACSs.<sup>49</sup> However, to protect retail investors, an ACS must not allow retail investors to be participants in a scheme unless they invest £1 million or more.<sup>50</sup>

### ***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 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.<sup>51</sup>

A UCITS scheme must comply with the following criteria: it must be an AUT, an OEIC or an ACS; the sole object of a UCITS scheme must be collective investment in

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

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

45 SI 2013/1388.

46 Section 235A FSMA.

47 Section 237(3) FSMA.

48 Section 261D(1) FSMA.

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

50 Section 261E FSMA.

51 SI 2011/1613.

transferable securities<sup>52</sup> or in other permitted financial instruments<sup>53</sup> operating on the principle of risk-spreading; and 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,<sup>54</sup> as well as specific investment and borrowing power rules.<sup>55</sup> 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.<sup>56</sup> 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.<sup>57</sup>

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 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 (AFMs) of UK UCITS schemes.<sup>58</sup> The rules applicable to UK management companies make clear that they are subject to a range of general compliance and conduct requirements contained in

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52 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)).

53 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 movable or immovable property that is essential for the direct pursuit of the OEIC's business.

54 COLL 1.2.2 and COLL 3.2.8.

55 COLL 5.2 to COLL 5.5.

56 COLL 5.2.

57 COLL 5.8.2.

58 COLL 12.

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.<sup>59</sup> 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,<sup>60</sup> and the rules in COLL and the conduct of business rules to which the EEA management company is subject.<sup>61</sup> These include detailed rules on:

- a* the issue and redemption of units in a UCITS scheme;
- b* investment policies and limits;
- c* the calculation of the value of the scheme property;
- d* the distribution of income;
- e* disclosure and reporting requirements; and
- f* marketing requirements.

### ***Non-UCITS retail schemes***

Like UCITS schemes, non-UCITS retail schemes (NURSSs) are not a separate type of investment vehicle, but rather are AUTs, OEICs or ACSs that do not comply with the requirements to be a UCITS. The regulatory regime applying to NURSSs in the UK is less stringent than that which applies to UCITS schemes, and the applicable investment restrictions are therefore more relaxed. However, as a consequence, NURSSs will not qualify for EU cross-border passporting under the UCITS regime.<sup>62</sup> For example, NURSSs 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.<sup>63</sup> In addition, the limit for investment in the units of another authorised scheme is 35 per cent of the NURSS's assets<sup>64</sup> (which permits a higher level of investment concentration than the 20 per cent limit applicable to UCITS schemes<sup>65</sup>), while the limit for a NURSS's exposure to a single counterparty in an over-the-counter derivative transfer is limited to 10 per cent of the scheme value,<sup>66</sup> rather than the usual 5 per cent limit for UCITS schemes.<sup>67</sup>

Nonetheless, there are still important limitations on the investment powers of NURSSs that are intended to retain a degree of investor protection in the absence of the demanding UCITS requirements. A NURSS (except for a feeder NURSS<sup>68</sup>) cannot invest in the units of a CIS unless that CIS meets certain minimum requirements, including that the CIS is effectively subject to an equivalent level of regulation as a NURSS or UCITS fund (or

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59 COLL 12.2.

60 COLL 12.3.4.

61 COLL 12.3.5.

62 See the guidance in COLL 5.6.2.

63 COLL 5.6.4 and COLL 5.6.5.

64 COLL 5.6.7(6).

65 See COLL 5.2.11(9).

66 COLL 5.6.7(5).

67 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).

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

otherwise that no more than 20 per cent by value of the NURS's assets are invested in that CIS); the CIS operates on the principle of the prudent spread of investment risk; and the CIS is prohibited from having more than 15 per cent in value of its property in units in other CISs.<sup>69</sup>

NURSs are also subject to certain of the same provisions in COLL regarding:

- a* limiting the amount of cash that can be retained in the scheme property;<sup>70</sup>
- b* general borrowing powers;<sup>71</sup>
- c* the ability to lend money and other property;<sup>72</sup> and
- d* the power to provide guarantees or indemnities.<sup>73</sup>

In October 2019, the FCA began consulting on proposals to reduce the potential for harm to retail investors in funds that hold illiquid assets.<sup>74</sup> This is of particular interest to NURSs, which invest in illiquid assets such as property. Under the FCA's proposals, funds may be required to suspend trading in certain circumstances, produce contingency plans, and disclose more information about liquidity risks.

### ***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).<sup>75</sup> 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.<sup>76</sup> 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.<sup>77</sup>

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69 COLL 5.6.10.

70 COLL 5.5.3.

71 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.

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

73 COLL 5.5.9.

74 FCA, Consultation Paper CP18/27, Consultation on illiquid assets and open-ended funds and feedback to Discussion Paper DP17/1.

75 COLL 5.7.2 and COLL 5.7.7.

76 COLL 5.7.9.

77 COLL 5.7.11.

### ***Qualified investor schemes***

As with UCITS schemes and NURs, 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,<sup>78</sup> 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.<sup>79</sup>

The regulation of QISs is more relaxed than that of UCITS schemes and NURs, 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,<sup>80</sup> 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.<sup>81</sup> Unlike UCITS schemes and NURs, 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.<sup>82</sup> 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).<sup>83</sup>

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.<sup>84</sup> 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.

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78 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).

79 COLL 8.1.3.

80 COLL 8.4.3.

81 COLL 8.4.4.

82 COLL 8.4.2.

83 COLL 8.4.5.

84 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 and be approved as such by HM Revenue & Customs (HMRC).

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 LR's contains specific rules with which listed closed-ended investment funds (which includes investment trusts) must comply.<sup>85</sup> In addition to meeting the minimum requirements for listing that apply to all listed securities, the LR's stipulate that investment trusts must invest and manage their assets in such a way as to spread investment risk,<sup>86</sup> and that the board of directors of the investment trust must be able to act independently from its investment manager.<sup>87</sup> 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.<sup>88</sup>

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,<sup>89</sup> investment trusts do not qualify as CISs, and therefore the restrictions on the promotion of CISs in Section 238 FSMA do not apply.<sup>90</sup> 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.

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85 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.

86 LR 15.2.2.

87 LR 15.2.11.

88 LR 15.4.2 and LR 15.4.8.

89 SI 2001/1062.

90 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.<sup>91</sup> 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.<sup>92</sup> 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 are treated as fiscally transparent in the UK. 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.<sup>93</sup>

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.<sup>94</sup>

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 in an arrangement whereby investors do not have day-to-day control over the management

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91 Section 4 LPA 1907.

92 Section 6(1) LPA 1907.

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

94 *ibid.*

of the fund's property. In addition, such limited partnerships are likely to be AIFs for the purposes of the AIFMD (see Section III.iii). 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 activities 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: it must be constituted by an agreement in writing, and 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).<sup>95</sup> The PFLP 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,<sup>96</sup> 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.<sup>97</sup>

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.<sup>98</sup> In practice, this will depend upon how the LLP is established and operates. Unlike limited partnerships, every member of the LLP is

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

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

97 Section 3 Limited Liability Partnerships Act 2000.

98 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.

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.<sup>99</sup> 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 (AIFM Regulations),<sup>100</sup> has resulted in a further regulatory category for investment funds: alternative investment funds (AIFs). An AIF is a collective investment undertaking<sup>101</sup> 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.<sup>102</sup>

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.<sup>103</sup> 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 NURSSs 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 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.<sup>104</sup> Managing an AIF means performing at least risk management or portfolio management for the AIF.<sup>105</sup> The AIFM may be an external manager or, if the legal form of the AIF permits internal management, the AIF itself.<sup>106</sup>

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 overlap, in that managers of NURSSs and QISs who are authorised as AIFMs must refer to the new Sourcebook as well as to COLL. Where there is a conflict between a rule implementing the

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

100 SI 2013/1773.

101 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.

102 Regulation 3(1) AIFM Regulations.

103 Regulation 3(2) AIFM Regulations.

104 Regulation 4(1) AIFM Regulations.

105 Regulation 4(2) AIFM Regulations.

106 Regulation 4(3) AIFM Regulations.

AIFMD and another rule in the FCA Handbook, the AIFMD requirements will prevail.<sup>107</sup> The AIFMD Level 2 Regulation,<sup>108</sup> 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.<sup>109</sup> For an internally managed AIFM, this is at least €300,000, while an external manager must have initial capital of at least €125,000, plus an additional amount of capital calculated on the basis of its assets under management.<sup>110</sup> Most asset management companies already hold substantial capital pursuant to the relevant EU capital requirements rules;<sup>111</sup> however, this was a new requirement for private equity funds;<sup>112</sup>
- 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),<sup>113</sup> 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.<sup>114</sup> 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

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107 FUND 1.1.2.

108 Regulation 231/2013.

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

110 Article 9 AIFMD.

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

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

113 Regulation 9 AIFM Regulations.

114 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.<sup>115</sup> 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).

### ***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 risks for each AIF under management and setting a maximum level of leverage.<sup>116</sup> AIFMs must also have adequate procedures and policies in relation to conflicts of interest.<sup>117</sup>

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.<sup>118</sup> 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.<sup>119</sup>

In respect of delegation, there are a number of restrictions.<sup>120</sup> An AIFM must notify the FCA before any delegation arrangements become effective, and the AIFM must be able to justify the delegation objectively.<sup>121</sup> 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.<sup>122</sup> Rules and guidance relating to the use of such

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

116 FUND 3.6.3 and 3.7.

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

118 SYSC 19B.1.2 and 19B.1.3.

119 SYSC 19B.1.18.

120 FUND 3.10.

121 FUND 3.10.2.

122 FUND 3.11.4.

depositories 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.<sup>123</sup>

The European Commission has proposed a revised legislative framework for prudential requirements for investment firms, set out in the proposed Investment Firms Regulation (IFR) and Investment Firms Directive (IFD). Political agreement was reached between the Council and the European Parliament in February 2019, and the texts are expected to be formally adopted later in 2019.

### ***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<sup>124</sup> 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.<sup>125</sup> 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.<sup>126</sup> 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.<sup>127</sup> 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

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123 FUND 3.9.

124 FUND 3.3.

125 Regulation 38 AIFM Regulations.

126 Regulation 43(1) AIFM Regulations.

127 Regulation 43(2) AIFM Regulations.

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.<sup>128</sup> The availability of the marketing passport was originally expected to be extended to non-EU AIFs and EU AIFs managed by non-EU AIFMs in certain jurisdictions in 2015, and possibly to non-EU AIFMs wishing to market into the EU from 2018.<sup>129</sup> However, this has since been delayed, and considering the demands of Brexit, it is not expected to be introduced in the near future.<sup>130</sup> If the regime is extended, non-EU AIFMs will have to be authorised by their Member State of reference,<sup>131</sup> and comply fully with the AIFMD, to take advantage of the passport.

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, an AIFM must comply with certain requirements, including notification to the FCA, and compliance with the transparency requirements and private equity provisions.<sup>132</sup> 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.

No changes have been made to the range of AIFs that may be marketed to the general public in the UK (including NURSSs and investment trusts) and the domestic rules on the promotion of AIFs to retail investors continue to apply, but each of these must now be managed by an authorised AIFM.

#### IV MAIN SOURCES OF INVESTMENT

An estimated £9.1 trillion of funds were under management in the UK at the end of 2017.<sup>133</sup> The UK is the second-largest global fund management centre, after the US, and is the largest centre of asset management in Europe, where it accounted for 35 per cent of all assets under management in 2018. Assets managed in London on behalf of European clients increased by almost 30 per cent from 2017 to 2018.<sup>134</sup> London is the leading centre for fund management in the UK, but other large fund management centres include Aberdeen, Liverpool, Manchester, Edinburgh, Bristol, Oxford, Cambridge, Glasgow and Birmingham.

The UK fund management industry has a strong international orientation: out of the £7.7 trillion of funds under management by IA members in 2017, £3.1 trillion was managed for overseas clients, which translated to earnings representing 6 per cent of net services

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128 See SUP 13.4.

129 Article 67 of the AIFMD provides the European Commission with the power to adopt a delegated act to such effect after receiving positive advice from the European Securities and Markets Authority (ESMA). Although ESMA published two pieces of advice on this subject in July 2015 and July 2016, it considers that it needs to conduct further assessments of certain jurisdictions.

130 See Section V of the European Overview chapter.

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

132 Regulations 57 and 59 AIFM Regulations.

133 IA, Asset Management in the UK 2017–2018, The Investment Association Annual Survey, September 2018.

134 All figures in this section are taken from the IA, Asset Management in the UK 2017–2018, The Investment Association Annual Survey, September 2018.

exports. In addition, £1.7 trillion of funds under management by IA members in 2017 was managed for overseas funds (up from £1.3 trillion at the end of 2016), of which 84 per cent consisted of funds domiciled in Ireland or Luxembourg.

Institutional clients provide the majority of funds under management in the UK, with nearly half of funds under management by IA members in 2017 managed for UK institutional clients. Within this metric, 63 per cent were managed for pension funds, and 25 per cent for insurance companies.

UK retail investor funds under management in UK authorised and recognised funds grew 15 per cent to £1.2 trillion in 2017. Of this, £147 billion was held in funds domiciled overseas. Net retail sales were £47.1 billion, of which £13.8 billion constituted sales of outcome and allocation funds, and £13.2 billion constituted fixed income funds. Equity growth sales were £10 billion, reflecting the fact that UK equity remains out of favour in the aftermath of the Brexit referendum.

## 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) and a move away from volatile equity markets.

### ii Concentration and consolidation

The top five fund managers by UK assets under management increased to 43 per cent of total funds under management from 39 per cent in 2015, and the top 10 managers for 58 per cent.<sup>135</sup> 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 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.<sup>136</sup> 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.<sup>137</sup> 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 acquisition by Canada Life Group (UK) of Retirement Advantages, the acquisition of L&G's mature savings business by Swiss Re and the acquisition by Amundi of Pioneer Investments.<sup>138</sup>

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135 IA, *Asset Management in the UK 2017–2018: The Investment Association Annual Survey*, September 2018.

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

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

138 IA, *Asset Management in the UK 2017–2018: The Investment Association Annual Survey*, September 2018.

### iii Corporate governance

The UK Stewardship Code (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. The FRC finished consultations on a new edition of the Stewardship Code in March 2019.<sup>139</sup> The proposed revised Stewardship Code includes new requirements for investors to report how their purpose, values and culture enable them to meet their obligations to clients and beneficiaries. It also refers to environmental, social and governance (ESG) factors, and expects investors to exercise stewardship across a wider range of assets where they have influence and rights (i.e., beyond listed equity). It also includes rules to promote disclosure on asset managers' engagement and investment strategies under the Revised Shareholder Rights Directive (SRD II). The IA published the executive summary of its response to the proposed revisions to the Stewardship Code in March 2019, voicing its concerns that, among other things, the revised definition of stewardship conflicts with asset managers' and owners' fiduciary duties, and the Stewardship Code is excessively prescriptive and insufficiently flexible. It remains to be seen whether these issues will be addressed when the finalised Stewardship Code is published later in 2019.

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.<sup>140</sup> They are also expected to ensure that managers are adhering to a fund's stewardship policy, and to seek to hold their managers to account for their stewardship activities.<sup>141</sup>

Since 6 December 2010, UK-authorized 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; as of 30 September 2016, managers and owners surveyed tended to have a public policy statement on how they will discharge their responsibilities under the Stewardship Code. Of the 77 asset managers surveyed, all except two were signatories to the Stewardship Code. Around half of the 51 asset owners surveyed were also signatories. In particular, asset managers noted that a large majority of their institutional clients expect them to exercise stewardship.<sup>142</sup> A further survey published in November 2018 found that all respondents (59 asset managers) except one were signatories to the Stewardship Code.<sup>143</sup> The FRC published a new edition of the UK Corporate Governance Code in July 2018,<sup>144</sup> with revisions aligned with those in the 2019 Stewardship Code. 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, stated that asset managers have become the dominant player in the investment chain, and the appointment and monitoring of asset managers is too often

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139 FRC, Proposed Revision to the UK Stewardship Code, January 2019.

140 See NAPE, UK Stewardship Code: Guidance for Investors, November 2010.

141 See NAPE, Stewardship Policy 2012, November 2012.

142 IA, Stewardship in Practice – Asset Managers and Asset Owners at 30 September 2016, September 2017.

143 IA, Stewardship in Practice – IA Stewardship Survey, November 2018.

144 FRC, The UK Corporate Governance Code, July 2018.

based on short-term relative performance.<sup>145</sup> The report recommended that asset managers should contribute more to the performance of businesses through greater involvement in the companies in which they invest, and suggested that the Stewardship Code should be developed to incorporate a more expansive form of stewardship, encompassing strategic issues as well as corporate governance.<sup>146</sup> In line with this recommendation, the 2012 edition of the Stewardship Code emphasised that stewardship should include matters of company strategy, and this is expected to be continued in the 2019 edition of the Code. The report also recommended 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 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, improve the quality of reporting and dialogue in the investment chain, and build trust-based relationships and align incentives through the investment chain.

#### **iv The Retail Distribution Review**

In June 2006, the FSA launched a review of retail distribution in the UK 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 firms. The 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 advisory services clearly as either independent or restricted. In addition, the rules require individual advisers to adhere to consistent professional standards.<sup>147</sup>

#### **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, published on 10 June 2015, set 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 government has implemented this change via the Bank of England and Financial Services

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

146 *ibid.*, p. 45.

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

Act 2016, which makes provision for the extension of the senior managers and certification regime to all UK authorised firms (including the asset management firms mentioned above). The FCA published near-final rules in July 2018.<sup>148</sup>

**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. The FCA published an interim report in November 2016, followed by its final report, together with a further consultation on implementing certain conclusions of the study in June 2017.<sup>149</sup>

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 of 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 the disclosure of an ‘all-in’ fee to investors, and the consistent and standardised disclosure of costs and charges to institutional investors. The FCA also stated that it would make a reference to the Competition and Markets Authority (CMA) to develop the FCA’s investigation to date into the investment consultant and fiduciary management sector. The CMA launched a market investigation into investment consultants on 14 September 2017, which culminated in the publication of a final report in December 2018 and a package of reforms, including a recommendation to HM Treasury to broaden the FCA’s regulatory scope to include the activities of investment consultants.<sup>150</sup>

In April 2018, the FCA finalised a number of the proposed remedies outlined in its final report, including measures to improve fund governance.<sup>151</sup> The proposed measures focus on the duty to act in the best interests of clients, in line with the FCA’s final report, and include rules that will require AFMs to carry out an assessment of whether funds managed

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148 FCA PS 18/14, Extending the Senior Managers and Certification Regime to FCA firms – Feedback to CP17/25 and CP17/40, and near-final rules.

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

150 CMA, Investment Consultants Market Investigation, Final Report, 12 December 2018.

151 FCA, Policy Statement PS18/8, Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CO17/18, April 2018.

by them will deliver value to investors. AFMs will then have to publish an annual statement assessing this value, either in the fund's annual report or in a separate report. Additionally, the new rules will make it easier for AFMs to move investors to cheaper but otherwise identical classes of the same fund by removing the need for an AFM to seek consent from each investor before converting them to a different share class. In February 2019, the FCA also set out final rules that require AFMs to explain why they have used a benchmark in a fund's prospectus and other consumer-facing communications that include fund-specific information and that, where an AFM describes a fund's past performance, it should describe such performance against the relevant benchmark.<sup>152</sup> The new rules also include requirements relating to how performance fees are calculated, and disclosure of fund objectives and investment policies.

## **vii Responsible and sustainable investment**

Growing concerns around the impact of climate change, along with increased scrutiny surrounding equality and diversity, has resulted in a marked growth of interest in responsible and sustainable investment, with an apparent increased integration of ESG factors across asset managers' strategies.

On climate change in particular, there has been a hive of activity in recent years. In 2017 the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) developed voluntary, climate-related financial risk disclosures, with the aim of providing decision-useful information to companies' stakeholders. In the UK, there has also been growing interest in climate-related financial risks among its regulatory bodies. In 2018, the FCA published a discussion paper on climate change and green finance, which considers, among other things, a 'comply or explain' approach to the TCFD's disclosures.<sup>153</sup> And in April 2019, the PRA and FCA hosted the first meeting of the Climate Financial Risk Forum, bringing together representatives from across the financial sector, including asset managers, in order to share best practice and produce practical guidance to further the financial sector responses to the financial risks from climate change.

## **VI SECTORAL REGULATION**

### **i Insurance**

The UK insurance industry is the largest in Europe and the fourth-largest in the world. It contributes significantly to the UK economy, managing investments of over £1.8 trillion and paying nearly £12 billion in taxes to the government.<sup>154</sup> UK insurance funds totalled over £1.1 trillion in 2016, which represented close to 13 per cent of funds under management in the UK. Around 55 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.<sup>155</sup>

In terms of asset allocation, the proportion of UK quoted shares held by insurance companies was estimated at 4.9 per cent at the end of 2016, continuing the fall seen in recent years and the lowest percentage since 1963 (when records began).<sup>156</sup> This decrease reflects

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152 FCA, Policy Statement PS19/4, Asset Management Market Study – further remedies, February 2019.

153 FCA, Discussion Paper DP18/8, Climate Change and Green Finance, October 2018.

154 Association of British Insurers, UK Insurance & Long-term Savings – Key Facts, December 2018.

155 TheCityUK, UK Fund Management. April 2018.

156 Office of National Statistics, Ownership of UK Quoted Shares: 2016, 29 November 2017.

a move from investment in equities to bonds and alternative investments, and for greater diversification overseas. This trend is partly attributable to the relative under-performance of stocks. Insurers may also have been pushed to become more cautious by solvency requirements.<sup>157</sup> 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),<sup>158</sup> 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 now 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<sup>159</sup> were made on 6 March 2015, making 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.

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 reference to fluctuations in any index that is not an approved index,<sup>160</sup> 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 direct investment risk is borne by a policyholder who is a natural person (e.g., a defined contribution pension scheme member) 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. Insurers offering linked policies to policyholders that are not natural persons now fall outside the rule in COBS 21.3.1 and so are able to link benefits to any type of asset as long as they continue to comply with relevant prudential requirements.<sup>161</sup>

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

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

158 Directive 2009/138/EC.

159 SI 2015/575.

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

161 See FCA, Policy Statement PS15/8, Solvency II, March 2015 and FSA, Consultation Paper CP11/23, Solvency II and linked long-term insurance business, November 2011.

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.<sup>162</sup> 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 a 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.<sup>163</sup> 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 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.<sup>164</sup> 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.<sup>165</sup> 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

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

163 See Section II.i.

164 Section 34 Pensions Act 1995.

165 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.

f the extent (if any) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.<sup>166</sup>

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).<sup>167</sup>

Regulation 4 of the Pension Schemes Regulations sets out the manner in which trustees' investment powers in relation to a scheme's assets must be exercised and the restrictions on the assets in which trustees can invest. The scheme's assets must be invested in the best interests of the members and beneficiaries.<sup>168</sup> 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.<sup>169</sup> 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.<sup>170</sup> In addition, derivative instruments may only be used to the extent that they contribute to a reduction of risks or facilitate efficient portfolio management.<sup>171</sup>

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.<sup>172</sup> In addition, pension schemes are not restricted from investing in qualifying insurance policies,<sup>173</sup> 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.<sup>174</sup>

There is a further requirement for defined benefit pension schemes in Regulation 4(4), which prescribes that the assets held to cover a 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,

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166 Regulation 2(3) Occupational Pension Schemes (Investment) Regulations 2005.

167 Section 36 Pensions Act 1995.

168 Regulation 4(2) Occupational Pension Schemes (Investment) Regulations 2005.

169 Regulation 4(3) and (7) Occupational Pension Schemes (Investment) Regulations 2005.

170 Regulation 4(5) and (6) Occupational Pension Schemes (Investment) Regulations 2005.

171 Regulation 4(8) Occupational Pension Schemes (Investment) Regulations 2005.

172 Regulation 4(9)(a) Occupational Pension Schemes (Investment) Regulations 2005.

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

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

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.<sup>175</sup> FRS102, which is mandatory for accounting periods beginning on or after 1 January 2015, also contains this requirement.<sup>176</sup>

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 six million savers and £350 billion in defined contribution assets without automatic enrolment).<sup>177</sup>

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 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 this has not yet come into force.

On 18 June 2018, the Department for Work and Pensions published a response to the Law Commission's report on social impact investing.<sup>178</sup> The response also announced the launch of its consultation to clarify and strengthen trustees' investment duties.<sup>179</sup> From 1 October 2019, trustees will be required, among other things, to update their statement of investment principles to clarify how they take account of financially material considerations, including: ESG issues such as climate change; their policies on the stewardship of investments; and a statement on how they will take account of members views of, for example, ESGs. The government considers that these new policies align with the FCA's proposed changes in relation to regulated pension fund activities.

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

176 Section 28: Employee Benefits.

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

178 Law Commission, Pension Funds and Social Investment, June 2017.

179 Department for Work and Pensions, The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018, June 2018.

### 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 actually companies that invest specifically in real estate and receive an advantageous tax treatment in that profits and gains arising from the company's property rental business are exempt from corporation tax. In order to obtain this tax treatment, a number of detailed conditions have to be fulfilled and notice must be given to HMRC.<sup>180</sup> These conditions include requirements that the REIT distributes at least 90 per cent of the profits from its real estate investment business and that the REIT's ordinary share capital is listed or admitted to trading (and is actually trading) on a recognised stock exchange. The latter requirement is satisfied if the shares are traded on the Alternative Investment Market (AIM) of the London Stock Exchange or a similar recognised stock exchange overseas. REITs must also be widely held, unless they are owned by certain 'institutional investors' such as pension funds.

The British Property Federation website listed 51 UK REITs as of June 2019.<sup>181</sup> Data published by the Property Industry Alliance (PIA) indicates that in 2016, UK REITs and listed property companies together held commercial property valued at £74 billion<sup>182</sup> (as compared to £65 billion in 2014).<sup>183</sup>

UK REITs are not CISs for the purposes of the definition in Section 235 FSMA; however, they may be AIFs.<sup>184</sup> 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.<sup>185</sup>

#### *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 vehicle for a property investment business. In contrast to REITs, PAIFs do not need to be listed or traded on a recognised stock exchange,

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180 Formerly, an entry charge based on the real estate asset value also had to be paid, but this was abolished under Finance Act 2012.

181 [www.bpf.org.uk/reits-and-property-companies](http://www.bpf.org.uk/reits-and-property-companies).

182 PIA, Property Data Report 2017, September 2017.

183 PIA, Property Data Report 2015, October 2015.

184 See the discussion of CISs in Section II.

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

but they must be structured as OEICs, meaning that 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 a number of detailed conditions have to be fulfilled and the fund manager must have given notice to HMRC for the PAIF rules to apply. Once an OEIC comes within the ambit of the regime, it benefits from favourable corporation tax treatment relating to its property investment businesses.

#### **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.<sup>186</sup> 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 earlier, investment trusts are not CISs for the purposes of the FSMA and do not 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 (predecessor to the FCA) 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.<sup>187</sup> 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 regulator has become increasingly interested in the activities of hedge funds, and the potential systemic risks posed by such funds, particularly as counterparties to trades with financial institutions and others within the financial markets.<sup>188</sup> 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,<sup>189</sup> the managers of which will not be required to comply

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186 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.

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

188 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.

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

with the AIFMD but will nevertheless likely require FCA authorisation for carrying out regulated activities as described above.<sup>190</sup> 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 that regime.

In 2008 the Standards Board for Alternative Investments (SBAI) (the Hedge Fund Standards Board, as it then was) was established to act as an industry body to represent hedge funds and to improve standards across the hedge fund industry. The SBAI 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.<sup>191</sup> 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 August 2018, 130 hedge fund managers with combined assets under management of over US\$1 trillion had committed to the Hedge Fund Standards.<sup>192</sup>

## 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 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.<sup>193</sup> Fundraising in the private equity sphere has improved significantly in recent years, with 2017 being the fifth consecutive year in which private capital fundraising surpassed the US\$300 billion mark.<sup>194</sup> Preqin, the alternative investment industry analyst, has noted that prices for assets have been at the forefront of investors’ and fund managers’ minds, although this did not affect the strong fundraising levels. A keynote address by Johannes Huth of KKR in the 2018 Preqin report noted that the UK’s decision to leave the European Union unleashed considerable volatility in the sterling exchange rate, and the full consequences of this event are yet to play out, with one particular concern being that the UK has a substantial current account deficit, meaning it is more vulnerable to shocks as compared with the eurozone, which currently has a current account surplus.<sup>195</sup> However, it remains to be seen to what extent the UK’s exit from the EU will have a significant impact on private equity fundraising or investment in the UK.

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

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190 *ibid.*

191 The SBAI, *The Hedge Fund Standards* (11/2015), 5 November 2015.

192 The SBAI, *Annual Report 2018*.

193 TheCityUK, *UK Fund Management*, April 2018.

194 Preqin, *2018 Preqin Global Private Equity & Venture Capital Report*, 2018.

195 *ibid.*

disclosure by private equity bodies.<sup>196</sup> These voluntary guidelines recommend that private equity firms that meet certain specified criteria<sup>197</sup> should publish annual reviews or regular updates on their websites containing information about their investment approaches and portfolios. In addition, the Walker 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 subsequently released in January 2011 following feedback from industry participants.<sup>198</sup> 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 changed, however, following the implementation of the AIFMD, as managers of private equity funds fall within the scope of the regime. The private equity industry has voiced concerns over the potential impact of the AIFMD on private equity activities.<sup>199</sup> 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.

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

197 Under the Walker 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'.

198 ILPA, *Private Equity Principles*, version 2.0, January 2011, available at [ilpa.org/ilpa-private-equity-principles](http://ilpa.org/ilpa-private-equity-principles).

199 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'.

Managers of certain venture capital funds may benefit from the European Venture Capital Funds Regulation (VCF Regulation).<sup>200</sup> 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 a sovereign wealth fund (SWF) of its own, London remains a popular location for foreign 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 19 per cent in 2016 to a record US\$7.4 trillion.<sup>201</sup>

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 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<sup>202</sup> 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.<sup>203</sup> 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

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200 Regulation 345/2013.

201 TheCityUK, UK Fund Management, April 2018.

202 Regulation 139/2004.

203 Section 59 Enterprise Act 2002.

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 US\$4.3 trillion in the third quarter of 2017.<sup>204</sup> 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 through providing certain reliefs for such investors from UK income and capital gains tax. VCTs, like investment trusts, are not trusts, but companies that are admitted to trading on a regulated market in the EU. They invest in securities issued by small unquoted<sup>205</sup> 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. To be treated as a VCT, a company must meet a number of detailed conditions and be approved as such by HMRC.

## **VII TAX LAW**

### **i Taxation at the level of the investment vehicle**

#### ***Taxation of domestic funds***

Taxation at the fund level is determined by the type of fund vehicle and, depending on the vehicle type, detailed eligibility criteria may have to be met and notifications given to, or approvals obtained from, HMRC before the desired treatment is available. The table below provides a high level summary of the UK tax treatment by vehicle type and, for these purposes, it is assumed that, in each case, all applicable eligibility criteria have been met and notifications given to, or approvals obtained from, HMRC.

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204 TheCityUK, UK Fund Management, April 2018.

205 In Section VCM55180 of HMRC's Venture Capital Schemes Manual, HMRC indicates that shares traded on AIM are regarded as unquoted for the purposes of the VCT regime.

Type of vehicle	Taxation of income	Taxation of realised capital gains
Investment trust	Dividend income generally exempt Non-dividend income generally taxable at 19%* Distributions to investors tax deductible (to the extent made up of interest income) if an election is made	Exempt
Authorised investment funds (OEIC/AUT)	Dividend income generally exempt Non-dividend income generally taxable at 20% Distributions to investors tax deductible (to the extent made up of interest income) if more than 60% of the vehicle's investments are debt instruments or similar investments	Exempt
PAIF	Dividend income generally exempt Income from real estate investment exempt All other income taxable at 20% Distributions to investors not tax deductible	Exempt
REIT	Dividend income generally exempt Income from real estate investment exempt All other income taxable at 19%* Distributions to investors not tax deductible	Gains from real estate investments exempt Gains from other investments taxable at 19%*
Exempt UUT	Typically no tax payable: whilst income is taxable at 20%, all income is deemed to be distributed to investors annually and that distribution is treated as tax deductible	Exempt
Non-exempt UUT	Dividend income generally exempt Non-dividend income taxable at 19%* Distributions to investors not tax deductible	Gains taxed at 19%*
VCTs	Dividend income generally exempt Non-dividend income generally taxable at 19%* Distributions to investors not tax deductible	Exempt
Authorised contractual scheme	Fiscally transparent  (Investors are treated as directly receiving a share of income subject to the scheme)	n/a  (The scheme is not a separate entity for tax purposes and not subject to UK tax on capital gains, but investors are treated as owning interests in the scheme rather than a share of the capital assets subject to the scheme)
Limited partnership	As for authorised contractual schemes	Fiscally transparent  (Investors are treated as owning a share of the limited partnership's capital assets)
Limited liability partnership	As for authorised contractual schemes	As for limited partnerships

\* The UK corporation tax rate is due to decrease to 17% from 1 April 2020.

### ***Taxation of foreign funds***

Subject to certain exceptions (some of which are highlighted below), a foreign fund would not be subject to UK tax unless it carries on a trade in the UK, and a foreign fund will not be treated as carrying on a trade in the UK merely by virtue of engaging an independent investment manager in the UK to carry out transactions on its behalf, provided that certain conditions as to the manager's activities, relationship with the foreign fund and remuneration are met.<sup>206</sup>

Even if a foreign fund does not carry on a trade in the UK, the fund may be liable to tax in the UK in the form of:

- a withholding taxes on UK-source payments, such as payments of annual interest, royalties and rent. The UK does not, however, impose any withholding tax on the payment of dividends;
- b stamp taxes on the transfer of shares, certain other marketable securities and UK real estate; and
- c taxes on income from a UK property business and taxes on gains from the disposal of UK real estate under a new regime enacted as part of the Finance Act 2019 (new NRCGT regime). With effect from April 2019, foreign funds may be liable to UK tax on any gain realised on the disposal of UK real estate or in a UK real estate rich company. The manner in which the new NRCGT regime applies would depend on the structure of the foreign fund. In addition, certain elections may be available under the new NRCGT regime to modify the default tax treatment of the fund as well as the investors.

### **ii Taxation at the level of the investor**

What follows below is a high level summary of certain UK tax rules that may affect all investors irrespective of their jurisdiction of tax residence or foreign investors. A detailed discussion of the tax treatment of different types of UK tax resident investors is beyond the scope of this publication.

### ***Taxation of investors in domestic funds***

The following table summarises certain key aspects in respect of the taxation of investors in domestic funds irrespective of their jurisdiction of tax residence.

Type of vehicle	Withholding tax on profit distributions to investors	Stamp taxes on transfer of interests in fund
Investment trust	No	Payable on transfers of shares
Authorised investment fund (OEIC/AUT)	No	Generally exempt
PAIF	20% in respect of distribution made up of income and gains from real estate, but exemptions (e.g., payment to UK companies) may apply or treaty relief may be available  No, in respect of other distributions	Generally exempt

<sup>206</sup> Sections 1142 and 1146 Corporation Tax Act 2010. See also HMRC Statement of Practice 1 (2001) (as amended).

Type of vehicle	Withholding tax on profit distributions to investors	Stamp taxes on transfer of interests in fund
REIT	20%, unless an exemption applies (e.g., payment to UK companies) or treaty relief is available (but note that holdings in REITs of over 10% attract a tax penalty, so having a qualifying shareholding of a size that avoids source taxation under the dividends article will generally not apply)	Payable on transfers of shares
UUT (exempt or non-exempt)	No	Generally exempt
Authorised contractual scheme	Fiscally transparent  (No withholding tax on fund distributions, but withholding tax applicable on payments to the scheme may be affected by investor identity and tax residence)	Generally exempt
Limited partnership	As for authorised contractual schemes	Payable on transfers of partnership interest only if partnership assets include shares, certain other marketable securities or UK real estate
Limited liability partnership	As for authorised contractual schemes	As for limited partnerships

### *Foreign investors investing in UK real estate*

Under the new NRCGT regime, foreign investors in domestic or offshore funds holding UK real estate or shares in UK real estate rich companies may be subject to UK tax on a disposal of their interest in the fund or, if the fund is treated as fiscally transparent for the purpose of the UK taxation of capital gains, a disposal by the fund of such real estate or shares. As indicated above, the manner of application of the rules depends on a number of factors and a detailed discussion of these rules is beyond the scope of this publication.

Foreign investors may also be subject to UK tax in respect of REIT or PAIF distributions to the extent that they are made up of income and gains from the REIT's or PAIF's real estate investment or, if they have invested in a domestic or foreign fund that is treated as fiscally transparent for the purpose of the UK taxation of income profits, in respect of income from a UK real estate business carried on by that fund.

## VIII OUTLOOK

### **i Brexit and the transition period**

Brexit and its potential impact on the UK financial sector continue to be topics of discussion. On 19 March 2018, the government published a draft withdrawal agreement, which provides for a transition period of a little under two years (ending 31 December 2020) during which the UK would continue to be subject to EU law and would benefit from the same rights as at present (e.g., passporting). At the time of writing, the withdrawal agreement has been rejected three times by Parliament, and the government has agreed an extension to the UK's 'exit day', which has been set as 31 October 2019. There remains considerable uncertainty about whether the UK and the EU will reach agreement on the withdrawal agreement (including the envisaged transition period) and, thereafter, the extent to which Brexit will be 'hard' or 'soft'. Asset managers have generally already implemented their contingency plans, but the IA stated in March 2019 that it was 'extremely disappointed' in the failure of the British

government to pass the withdrawal agreement and the continued uncertainty surrounding Brexit, citing the fact that, since the referendum, nearly £15 billion has been withdrawn from UK equity funds by British savers.<sup>207</sup> It stressed that avoiding a no-deal exit was paramount.

Statements made by ESMA in July 2017 raised doubts about the continuing viability post-Brexit of the ‘delegation model’ employed by many international fund management groups, in which a fund manager authorised in one country delegates fund management or advisory duties to an affiliate in another jurisdiction (which may be outside the EU).<sup>208</sup> More recently, however, the Chair of ESMA, Steven Maijoor, noted that ESMA is not seeking to undermine or put in doubt the delegation model. ESMA acknowledges that the delegation model is a key feature of the investment funds industry that has contributed to the success of the industry by providing the requisite flexibility to organise centres of excellence in different jurisdictions. ESMA has sought to clarify that it does not envisage changing the legal requirements, but is rather seeking to aid their practical application and help authorities when supervising delegation arrangements so that national regulators would be able to interpret the requirements consistently.<sup>209</sup> In support of this, ESMA signed a memorandum of understanding (MOU) with the FCA in February 2019 ensuring that asset managers would continue to be able to employ the delegation model in a scenario where the UK leaves the EU without a deal.

## **ii Senior managers and certification regime**

The senior managers and certification regime (SMCR), which currently covers banking firms, and to a more limited extent insurers, is being extended to all FCA solo-regulated firms, including asset managers. While the implementation date for FCA solo-regulated firms is expected to be 9 December 2019, the FCA has published ‘near final’ rules for the regime’s extension.

The FCA has sought to adopt a proportionate approach to the extension, reflecting the diverse businesses across the financial services sector and the different sizes and complexities of individual firms. Firms will be categorised as ‘limited’, ‘core’ or ‘enhanced’, largely based on size, with a different level of requirements applying to each. However, the FCA will have discretion to elevate smaller but more complex asset managers to the category of ‘enhanced’ if it believes such firms merit greater scrutiny, which will require them to comply with a broader set of requirements.

The new regime will require all firms to:

- a* identify their senior manager functions (SMFs) and prepare SMF statements of responsibilities;
- b* identify employees within the certification regime, and, for ‘enhanced’ firms, prepare ‘responsibilities maps’ setting out the firm’s management and governance arrangements; and
- c* identify SMF handover procedures.

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207 IA, Investment Association responds to the meaningful vote, 12 March 2019.

208 European Securities and Markets Authority, Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union, 13 July 2017.

209 ESMA, Keynote Address, CMU, Brexit and ESA review – What’s next?, 20 March 2018.

Senior managers will be subject to conduct rules and a duty of responsibility in relation to the business areas they head up. A prescribed responsibility will apply to AFMs, which requires a senior manager (usually the chair) to take reasonable steps to ensure the firm complies with its obligation to carry out an assessment of value, its duties relating to independent directors and to act in the best interests of fund investors.

Applying the rules may be more challenging for asset managers, where partnerships and flatter operating structures are more common.

### **iii Regulatory scrutiny**

In its business plan for 2019 to 2020, the FCA identified certain priority themes. The areas that are of particular significance to the asset management industry are:

- a* investment management (including implementing the rule changes following the asset management market study, the implementation of the Revised Shareholder Rights Directive, and consultation on a new prudential regime for MiFID investment firms);
- b* pensions (including the implementation of further remedies arising from the FCA's Retirement Outcomes Review); and
- c* wholesale financial markets (including the continued implementation of the market abuse and MiFID regimes, and the replacement of LIBOR).

# ABOUT THE AUTHORS

**PAUL DICKSON**

*Slaughter and May*

Paul Dickson is a partner at Slaughter and May with a broad corporate and commercial practice. He has experience of advising clients on a wide range of corporate matters, including in the field of asset management, as well as on M&A transactions, private acquisitions and disposals, and joint ventures and partnership structures.

**SLAUGHTER AND MAY**

One Bunhill Row  
London  
England EC1Y 8YY  
United Kingdom  
Tel: +44 20 7600 1200  
Fax: +44 20 7090 5000  
paul.dickson@slaughterandmay.com  
www.slaughterandmay.com



ISBN 978-1-83862-057-8