Fund Management

2018

GETTING THE DEAL THROUGH

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Fund Management 2018

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Preface

Fund Management 2018

Fourth edition

Getting the Deal Through is delighted to publish the fourth edition of *Fund Management*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on Hong Kong and Luxembourg.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise.

London
May 2018

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United Kingdom

Michelle Moran and Rodney Smyth
K&L Gates LLP

Fund management

1 How is fund management regulated in your jurisdiction? Which authorities have primary responsibility for regulating funds, fund managers and those marketing funds?

Fund management is regulated in the UK by the Financial Services and Markets Act 2000 (FSMA), various statutory instruments made under the FSMA and the Financial Conduct Authority's (FCA) rules. EU directives are typically implemented in the UK by statutory instruments under the FSMA and changes to the FCA's rules. EU regulations apply directly in the UK, without any need for further implementation. In practice, though, where relevant, they are reproduced in the FCA's rules. The FCA is the body responsible in the UK for regulating funds, fund managers and the entities marketing funds.

Following the UK's referendum on continued membership of the EU in June 2016, there has been no change to UK law implementing EU directives, or to ongoing implementation in the UK of EU directives, and EU regulations still apply directly in the UK. However, the UK government has introduced the European Union (Withdrawal) Bill to repeal the European Communities Act 1972, which took the UK into the EU, and to incorporate EU law into domestic law, with effect from the 'exit' day – 29 March 2019. The Bill is now progressing through Parliament in the normal way. The Bill contains delegated powers to enable the government to adapt any laws on the statute book originating from the EU to the UK's new relationship with the EU, following exit. See 'Brexit' in question 26.

2 Is fund administration regulated in your jurisdiction?

Fund administration will usually constitute the regulated activity of 'establishing, operating or winding up a collective investment scheme', which requires authorisation by the FCA. In addition, any administrator providing custody services in relation to investments must be authorised by the FCA.

3 What is the authorisation or licensing process for funds? What are the key requirements that apply to managers and operators of investment funds in your jurisdiction?

The UK authorisation (licensing) process for funds is outlined in question 20 (retail funds) and question 31 (non-retail funds).

Depending on the precise activity undertaken, a manager or operator of an investment fund must be authorised by the FCA to carry on the following in the UK ('regulated activities'):

- managing an alternative investment fund (AIF) (typically, a non-retail fund);
- managing an undertaking for collective investment in transferable securities (UCITS) fund (typically, a retail fund);
- managing investments (eg, a manager not directly managing a fund, but doing so as a delegated investment manager appointed by the direct fund manager or a manager managing assets of a single investor (in a segregated account));
- advising on investments (in the case of a manager giving advice without the power to invest the assets advised upon);
- establishing, operating or winding up a collective investment scheme (in the case of an entity that operates a collective investment scheme but does not manage the scheme). Operating generally means being responsible for administering the scheme (eg, for the execution of orders to buy or sell fund shares or units, maintaining a register of fund investors, fund accounting and fund asset valuation); and
- arranging deals in investments (this is required for many intermediation activities, including entering into distribution agreements with independent financial advisers (IFAs) and issuing 'direct offer' advertisements).

4 What is the territorial scope of fund regulation? Can an overseas manager perform management activities or provide services to clients in your jurisdiction without authorisation?

The FSMA prohibits a person from carrying on a regulated activity (see question 3, for examples) in the UK without authorisation. Carrying on a regulated activity without authorisation is a criminal offence and any contract made in the course of carrying on an unauthorised activity is unenforceable against an investor. A person will carry on a regulated activity if it does so 'by way of business', which means carrying on the business of engaging in the activity. There is an exclusion for investment managers that are overseas persons. These are persons who carry on a regulated activity in the UK, other than from 'a permanent place of business maintained by them in the UK'. To rely on this exclusion, the overseas manager's contacts with UK clients must either be unsolicited by the manager or solicited by it in compliance with the UK financial promotion rules (see question 8).

5 Is the acquisition of a controlling or non-controlling stake in a fund manager in your jurisdiction subject to prior authorisation by the regulator?

Any person that 'decides' to acquire 'control' over an FCA-authorised firm must obtain the FCA's consent before the acquisition. 'Control' for this purpose is holding 10 per cent or more of the shares or voting power in the firm (or its parent undertaking) or holding shares or voting power as a result of which the holder is able to exercise significant influence over the management of the firm (20 per cent for firms that are solely authorised to manage AIFs (see question 24)). Any person deciding subsequently to hold 20, 30 or 50 per cent of the shares or voting power must again obtain the FCA's prior consent (30 or 50 per cent for managers of AIFs (AIFMs)).

6 Are there any regulatory restrictions on the structuring of the fund manager's compensation and profit-sharing arrangements?

There are four sets of remuneration rules applying to specified senior employees of UK fund managers.

An investment manager that is, broadly, a firm other than an AIFM or a UCITS manager is governed by the FCA's BIPRU Remuneration Code (the BIPRU Code). An AIFM is governed by the FCA's Alternative Investment Fund Managers Directive (Directive 2011/61/EU (AIFMD)) Remuneration Code (the AIFMD Code). A UCITS manager is governed by the FCA's UCITS Remuneration Code (the UCITS Code). A manager may apply the rules in a way appropriate to its size, internal organisation and the nature, scope and complexity of its activities (the 'proportionality' principle). The requirements of each code are similar but not identical. In particular, the rules in the BIPRU Code requiring payment of part of the remuneration in equity of the fund or the manager and relating to deferral (ie, delayed payment) and the ratio

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of variable (bonus) to fixed remuneration are automatically disapplied in the case of most investment managers that are BIPRU investment firms, while the rules in the AIFMD and UCITS Codes relating to payment in equity and deferral may also be disapplied, but only on the basis of the amount and variable proportion of the employee's remuneration.

Some investment managers are 'IFPRU investment firms' (broadly, a firm with FCA permission to hold client money or assets, to deal on own account or to underwrite or place financial instruments) and are governed by the FCA's IFPRU Remuneration Code (the IFPRU Code). In particular, the IFPRU Code contains the 'bonus cap', so that the ratio of variable to fixed remuneration cannot exceed 1:1 (or 2:1 with shareholder approval) and all variable remuneration must be subject to clawback if there is subsequent poor performance.

The substance of the IFPRU Code will also apply where, broadly, a manager is part of a banking group.

Fund marketing

7 Does the marketing of investment funds in your jurisdiction require authorisation?

A UK investment fund will be classified either as a UCITS fund under the UCITS Directive (Directive 2009/65/EC) or an AIF under the AIFMD, unless it is a 'fund of one' (a fund vehicle exempt from the AIFMD, because it is servicing only a single investor). In broad terms, the marketing of a UCITS fund in the UK requires authorisation by the FCA (if it is UK-constituted) or notification to the FCA (if it is constituted in a European Economic Area (EEA) state other than the UK), while the marketing of an AIF in the UK again requires either authorisation by the FCA, if the AIFM is established in the UK, or notification to the FCA, if not. The notification procedure for non-UK AIFMs depends on whether or not both the AIFM and AIF are established in an EEA state other than the UK. If they are, they notify under an EEA-wide 'passporting' regime. If not, the UK 'national private placement' rules apply. Segregated accounts (mandates for a single investor) and joint ventures are outside the AIFMD and generally governed by terms negotiated by the relevant parties and rules derived from the EU Markets in Financial Instruments Directive II (Directive 2014/65/EU (MiFID II)). The marketing of segregated accounts and joint ventures is governed by the UK financial promotion regime (see question 9).

8 What marketing activities require authorisation?

Fund marketing activities in the UK are governed by the UK financial promotion regime (see question 9). In relation to funds, a financial promotion is an 'invitation or inducement' to invest in the fund and broadly covers all types of marketing activity (whether or not solicited by the investor). The concept of financial promotion is relevant to marketing both UCITS funds and AIFs and any other investment product or service. Under the UK AIFM regulations, there is, in addition, a more restricted concept of 'marketing', applying only to AIFMs. For these purposes, marketing is a 'direct or indirect offering or placement' by an AIFM at the initiative of or on behalf of the AIFM. It is generally interpreted as catching only the distribution of application forms, subscription agreements and similarly binding documents.

9 What is the territorial scope of your regulation? May an overseas entity perform fund marketing activities in your jurisdiction without authorisation?

The territorial scope of the UK financial promotion regime covers communications made within the UK and also promotions made from outside the UK to anywhere (inside or outside the UK) if they are 'capable of having an effect in the UK'. Note here that the 'UK' excludes the Channel Islands and the Isle of Man. A promotion communicated to a website accessible in the UK will be capable of having effect in the UK. There is an exemption for communications 'directed' only at persons outside the UK. Financial promotion in the UK is prohibited, unless the promotion is made or approved by an FCA-authorised person or exempted from the financial promotion regime. Breach of the prohibition is a criminal offence, and any contract resulting from a prohibited promotion is unenforceable against an investor. Authorised persons are subject, in turn, to FCA rules on financial promotion and specific FSMA restrictions on promoting funds. The FSMA permits authorised persons to promote UCITS funds to the general public. The FCA rules and the FSMA restrict the promotion of non-UCITS funds by authorised persons to limited categories of investor, broadly the same as the exempted categories (see below).

Exemptions from the financial promotion regime allow financial promotion in the UK by non-authorised persons, including non-authorised overseas entities, to certain limited categories of investor. The main exempted categories, all (except for most AIFs) subject to conditions as to contents, are:

- investment professionals, including UK and non-UK local authorities;
- high net worth companies;
- high value trusts, including private sector pension funds constituted as trusts; and
- for most AIFs permitted to be marketed in the UK (see question 7), also all other institutional investors and pension funds.

See question 26 for more details.

10 If a local entity must be involved in the fund marketing process, how is this rule satisfied in practice?

A local entity does not have to be involved in the fund marketing process in the UK. In practice, however, involving a locally authorised entity will facilitate marketing an AIF to individual investors (if desired), since an FCA-authorised firm can market an AIF to an individual it has certified as a sophisticated investor. Although in practice not straightforward, this is likely to be the most feasible way to market AIFs to individuals in compliance with the UK financial promotion rules. A sophisticated investor is an investor sufficiently knowledgeable to understand the risks associated with a proposed investment.

11 What restrictions are there on intermediaries earning commission payments in relation to their marketing activities in your jurisdiction?

A UK-authorised firm, such as an IFA, recommending a retail investment product, such as a UCITS, to a retail client other than a retail client outside the UK, can be paid for its advice only by fees agreed with the client. Payments, such as initial and trail (ongoing) commission, made by the product provider (typically, the fund manager) to the adviser are prohibited. In addition, where a retail client buys or sells a retail investment product through a platform service provider and no recommendation is made, the product provider may not offer or pay any related commissions.

Retail funds

12 What are the main legal vehicles used to set up a retail fund? How are they formed?

A retail fund will probably be established in the UK as an open-ended UCITS fund. An exchange-traded retail fund will typically be a UCITS fund listed on a stock exchange. Alternatively, a manager may establish a closed-ended vehicle, typically to invest in assets (such as real estate) in which a UCITS fund is not permitted to invest, and adopt the investment trust model (see below). An investment trust will typically be listed on a stock exchange to allow investors to realise their shares on the stock market and to enable a public offering of the shares (if desired).

Open-ended retail funds

Open-ended retail funds established in the UK are either UCITS funds or (much more rarely) non-UCITS retail schemes (NURS). A NURS is a type of non-UCITS fund authorised by the FCA for distribution to retail investors in the UK, with wider investment and borrowing powers than a UCITS – in particular, it can invest in real estate (land) and gold. In either case, the fund will be legally constituted in the UK as an open-ended investment company (OEIC), an authorised unit trust (AUT) or an authorised contractual scheme (ACS).

The term 'investment company with variable capital' is synonymous with OEIC. An OEIC is formed with an instrument of incorporation, at least one director and shareholders (investors). An OEIC must have an authorised corporate director (ACD), which must be an FCA-authorised person, responsible for managing the fund. Typically, the ACD is the OEIC's sole director. An AUT is a trust and, as such, has no separate legal personality under UK law. It is constituted by a trust deed made between the trustee and the fund manager.

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The trustee holds the assets (investments) on trust for the beneficiaries (investors), who are known as 'unitholders', since their beneficial interests are represented by 'units' under the trust. Unlike an OEIC or AUT, an ACS is a tax-transparent vehicle constituted either as a co-ownership scheme or limited partnership. A co-ownership scheme is constituted by an agreement between the fund manager and the depositary (custodian), under which the investors' rights to the assets are similar to those of AUT unitholders.

Any of these vehicles, except an ACS constituted as a limited partnership, can be an umbrella fund, with underlying sub-funds. The property of a sub-fund may be used only to discharge the liabilities of that sub-fund. Each sub-fund of an umbrella is therefore individually ring-fenced.

Closed-ended retail funds

Closed-ended retail funds established in the UK are typically companies listed on the London Stock Exchange's (LSE) Main Market (traditionally called investment trusts, although nowadays in corporate form). The Main Market is the most liquid market in the UK (offering the widest investor base). It is also a 'regulated market' under EU law. Funds listed on the Main Market can accordingly be marketed to retail investors and also qualify for inclusion in institutional investors' mandates limited to investments listed on a regulated market. Investment trusts must comply with requirements relating to, for instance, investment diversification, in order to qualify for favourable tax treatment (see question 18).

Some investment companies are traded on the LSE's Alternative Investment Market (AIM) or its Specialist Fund Market. AIM is an exchange-regulated market, not a regulated market under EU law. As such, it is generally easier and quicker for a fund to make an initial offering of its shares on AIM rather than on the Main Market (and also follow-on offerings), provided the offering is limited to institutional investors, because compliance with the EU Prospectus Directive (Directive 2003/71/EC) is not then required. The Specialist Fund Market is designed for specialist investment funds targeting only professional, institutional or knowledgeable investors. Compliance with the Prospectus Directive is required. There are also special LSE regimes for closed-ended funds investing in venture capital (venture capital trusts) and real estate (real estate investment trusts).

Most investment companies listed or traded on the LSE are classified as AIFs, with the exception of some real estate investment trusts, because they have a commercial, not an investment, purpose.

13 What are the key laws and other sets of rules that govern retail funds?

The establishment and operation of open-ended retail funds in the UK are governed by the FSMA, various statutory instruments made under the FSMA and the FCA's rules (in particular, the FCA's collective investment scheme (COLL) rules). In addition, from 31 December 2019, the EU Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation (Regulation (EU) No. 1286/2014) may apply to all UK open-ended retail funds. Currently, UCITS funds are exempted, but it is unclear whether the exemption will continue from that date. This Regulation requires a standardised pre-contractual key information document for each fund. If the Regulation applies, this would replace the equivalent key investor information document currently required by virtue of the UCITS Directive. Closed-ended retail funds constituted as companies are not collective investment schemes in UK terms, and are therefore subject only to FSMA and FCA financial promotion rules and, if listed on the LSE's Main Market, the FCA's Listing Rules or, if traded on AIM or the LSE's Specialist Fund Market, the rules of those markets.

14 Must retail funds be authorised or licensed to be established or marketed in your jurisdiction?

Open-ended retail funds

To be marketed in the UK, open-ended retail funds must either be authorised by the FCA (if established in the UK) or recognised by the FCA (if established outside the UK). Any entity established as an open-ended retail fund in the UK must be authorised by the FCA. Most non-UK funds recognised by the FCA are UCITS funds established in other EEA jurisdictions. The authorisation process is outlined in question 20.

Closed-ended retail funds

Closed-ended retail funds listed on the LSE's Main Market or traded on its Specialist Fund Market are not authorised as funds by the FCA, although the actual listing on the Main Market will require approval by the FCA in its capacity as the UK 'listing authority' and Main and Specialist Fund Market prospectuses will require its approval under EU 'approved prospectus' law. Closed-ended funds traded on AIM are also not FCA authorised, but will still be subject to the AIM rules. In addition, an AIM prospectus will require approval by the FCA if the shares are to be offered to retail investors. Any fund traded on AIM must appoint an independent adviser to act as a nominated adviser (NOMAD), whose function will be to confirm to the LSE the fund's compliance with the AIM rules.

15 Who can market retail funds? To whom can they be marketed?

Open-ended retail funds authorised or recognised by the FCA, and closed-ended retail funds listed on the LSE's Main Market or traded on its Specialist Fund Market, can be marketed to any type of investor in the UK (although, in practice, a fund traded on the Specialist Fund Market will not make a retail offering, because the LSE's guidance indicates that it will admit to that market only funds targeted at professional, institutional or knowledgeable investors). A fund traded on AIM is also, in practice, rarely offered to retail investors in the UK (any retail offering would require compliance with the Prospectus Directive, and AIM-traded funds typically seek to avoid this expense). However, UK retail investors can and do acquire shares in AIM-traded funds on the secondary (as distinct from primary) market.

An entity marketing a retail fund in the UK must be FCA-authorised if:

- it carries on a regulated activity in the course of marketing the fund, such as giving investment advice or arranging deals in investments; and
- it carries on that activity in the UK, subject to the overseas person exclusion described in question 4.

In practice, a professional UK fund distributor, such as an IFA, is normally FCA-authorised either because it gives investment advice to clients or because its distribution activities, such as taking clients' investment orders and transmitting their investment subscription monies, constitute the regulated activity of 'arranging deals' in investments.

16 Are there any special requirements that apply to managers or operators of retail funds?

The manager of a UK UCITS fund, or a UK NURS, established as an AUT must be independent from the AUT trustee and a body corporate established in the UK or another EEA state. The manager of a UK UCITS fund established as an OEIC will usually be the ACD of the OEIC (see question 12).

The manager of a UK UCITS fund must be authorised by the FCA to carry on the regulated activity of 'managing a UCITS' or may be a firm established in another EEA state operating under the EU UCITS management passport. The manager of a NURS (see question 12) must be authorised to carry on the regulated activity of managing an AIF. The manager of a closed-ended retail fund must be authorised by the FCA, typically to carry on the regulated activity of managing an AIF. Alternatively, the fund itself can be authorised as a self-managed AIF if it has no external AIFM.

Under product governance rules introduced in 2018 by MiFID II, a firm 'manufacturing' a new fund (ie, creating, developing, issuing or designing a new fund) must identify the fund's 'target market' of 'end (ultimate) clients', ensure its distribution strategy is compatible with that market and take reasonable steps to ensure the fund is in fact distributed to that market. Typically, it will be the manager or operator of a fund that will manufacture it for these purposes, although this will not necessarily preclude a primary distributor from also being a manufacturer. Although the rules apply to non-retail funds as well as retail funds, they will, in practice, have a greater impact on retail funds, simply because the end clients and distributors will be more numerous and identifying the target market and monitoring distributors will therefore be more difficult.

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17 What are the investment and borrowing restrictions on retail funds?

Open-ended retail funds

The investment and borrowing powers for UCITS funds are set out in the FCA's COLL rules, implementing the UCITS Directive. A UCITS fund can invest its portfolio in the following asset classes:

- transferable securities or money market instruments traded on an EEA regulated market. Transferable securities consist of shares, debt securities and other traded securities, such as depositary receipts. A regulated market is an EEA stock exchange classified as a regulated market under EU legislation;
- cash and near cash (including bank deposits and Treasury bills);
- units in other UCITS and non-EEA collective investment schemes, subject to conditions; and
- derivatives and forward transactions.

A UCITS fund is subject to investment spread and concentration requirements, including:

- up to 5 per cent of the fund's assets can be invested in transferable securities or money market instruments issued by a single body. The 5 per cent limit can be raised to 10 per cent for 40 per cent of the portfolio;
- up to 10 per cent of the fund's assets can be invested in unlisted securities;
- up to 20 per cent of the fund's assets can be invested in cash deposits with a single body;
- exposure to a single derivatives or broker counterparty cannot exceed 5 per cent of the fund's assets, except where the counterparty is an approved bank, where the exposure can be up to 10 per cent;
- up to 20 per cent of the fund's assets can be invested in transferable securities and money market instruments issued by the same group;
- up to 20 per cent of the fund's assets can be invested in units of (broadly) any one regulated collective investment scheme (eg, another UCITS fund) and up to 30 per cent in (broadly) all other regulated collective investment schemes;
- up to 35 per cent of the fund's assets can be invested in government or public securities – or 100 per cent, subject to conditions, including:
  - no more than 30 per cent can be invested in a single issue; and
  - the securities must come from at least six different issuers;
- the fund cannot hold more than 10 per cent of the debt securities issued by a single issuer;
- the fund cannot hold more than 25 per cent of the units or shares issued by a single collective investment scheme; and
- the fund cannot hold more than 10 per cent of the money market instruments issued by a single body.

A UCITS fund can borrow up to 10 per cent of the fund's assets on a temporary basis. It follows that, in practice, a UCITS fund cannot borrow for investment purposes, and so can do so only to cover redemptions of units or shares by selling investors.

A NURS has broader investment powers. It can invest in the investments permitted for UCITS schemes. It can also hold:

- 100 per cent of its assets in real property (land);
- up to 10 per cent of its assets in transferable securities issued by a single issuer;
- up to 10 per cent of its assets in gold;
- up to 20 per cent of its assets in unlisted securities; and
- up to 35 per cent of its assets in other collective investment schemes (including non-UK schemes whose investment and borrowing powers are equivalent to, or more restricted than, those of NURSs, and AIFs, provided that the combined value of unlisted securities and AIFs does not exceed 20 per cent of the NURS's assets).

In addition, a NURS authorised as a 'fund of alternative investment funds' can invest in a range of AIFs. A NURS can borrow up to 10 per cent of its assets on a permanent basis and, if it is an index-tracking fund, can invest up to 20 per cent of its assets in transferable securities issued by a single body.

Closed-ended retail funds

Closed-ended retail funds listed on the LSE's Main Market are not subject to restrictions on investment or borrowing, although, as a condition of listing, they must have a published investment policy covering asset allocation, risk diversification, gearing and maximum exposures as a condition of listing. In practice, a fund will have to draw up its own set of investment restrictions and require shareholder approval to amend them.

A UK closed-ended retail fund listed on the LSE's Main Market must satisfy certain investment conditions in order to qualify for favourable tax treatment. For example, the business of the company must consist of investing its funds in shares, land or other assets with the aim of spreading investment risk and giving members of the company the benefit of the results of the management of its funds.

18 What is the tax treatment of retail funds? Are exemptions available?

Open-ended retail funds

Subject to special rules applying to tax-elected funds, and property authorised investment funds, AUTs and OEICs are generally exempt from UK tax on gains on the disposal of investments (capital gains), but subject to corporation tax at a special rate of 20 per cent on income, although dividend income (primarily from shares) is exempt, subject to conditions, and deductions are available, subject to conditions, for amounts distributed by funds primarily invested in debt securities (bond funds) as interest distributions.

UK-resident individual fund investors will be subject to tax on dividend distributions made, or (if the fund accumulates its income) deemed to be made, subject to a £2,000 annual dividend allowance, with no withholding. These dividend distributions are generally tax exempt for UK corporation taxpayers, such as companies.

UK-resident individual investors in bond funds will have their interest distributions generally treated as interest for tax purposes, subject to an annual personal savings allowance under certain circumstances, with no withholding. UK corporation taxpayers will be subject to corporation tax on interest distributions, again with no withholding.

UK-resident individual fund investors are subject to capital gains tax on gains realised on the disposal of units or shares in an AUT or an OEIC. UK non-resident individual fund investors are generally not directly subject to UK tax, and there is no withholding.

For tax purposes, individual ACS investors will be treated broadly as if they had invested directly in the underlying assets, if the ACS is structured as a partnership, whereas an ACS structured as a co-ownership scheme is transparent for income tax purposes, but opaque for capital gains, which are therefore taxed at ACS-level.

Closed-ended retail funds

UK investment trusts are exempt from tax on capital gains, but otherwise generally subject to UK corporation tax at 19 per cent. Individual investment trust investors are taxed in the same way as individual shareholders in other UK companies, except that investment trusts primarily invested in debt securities can elect to be treated in broadly the same way as AUT and OEIC bond funds to the extent they receive interest income.

19 Must the portfolio of assets of a retail fund be held by a separate local custodian? What regulations are in place to protect the fund's assets?

Open-ended UK retail funds must appoint an independent entity (a custodian) to hold their assets. This must be a trustee, for an AUT, or a depositary, for an OEIC. A trustee must be independent from the manager and established in the UK, or, if established in another EEA state, have a place of business in the UK. A depositary must likewise be established in the UK, or, if established in another EEA state, have a place of business in the UK. Trustees and depositaries must be authorised by the FCA since these are regulated activities. They will be subject to the FCA's client asset (CASS) rules on custody of assets, which are intended to ensure that custodians observe professional standards of care and diligence, including in the appointment of sub-custodians. Depositaries of UCITS funds, and trustees, in the case of AUTs, are subject to strict liability for the loss of assets held in custody, similar to AIF depositaries (see question 30).

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Most closed-ended retail funds marketed in the UK are AIFs. Under the AIFMD, an AIF must appoint a depositary if the AIF is established and managed in the EEA (see question 30). Closed-ended retail funds not required under the AIFMD to appoint a depositary, because the fund or the AIFM is established outside the EEA (or the fund is managed by sub-threshold AIFMs – see question 25) will, in practice, appoint a custodian, where they hold assets, such as listed securities, requiring a custodian for trade settlement purposes.

20 What are the main governance requirements for a retail fund formed in your jurisdiction?

The registration and organisational governance requirements for UK UCITS funds established as AUTs, OEICs or ACSs are largely the same. All must be authorised by the FCA. Application is accordingly made to the FCA with:

- a draft prospectus;
- a draft instrument of incorporation, in the case of an OEIC;
- a trust deed, in the case of an AUT, or limited partnership agreement or co-ownership deed, in the case of an ACS;
- a model portfolio;
- an application form; and
- a solicitor's certificate confirming that the constitutional documents comply with the applicable regulations.

The FCA has two months in which to consider a UCITS application.

UCITS funds established elsewhere in the EEA can be recognised by the FCA for sale in the UK under the EU passporting process. Under this process, the UCITS manager provides a notification letter and the fund documentation to its EEA home state regulator, which then approves the application and sends the documents on to the FCA.

Certain schemes considered comparable to UK-authorisable schemes can also be recognised by the FCA for sale in the UK. In practice, though, such funds are seldom recognised, unless established in Guernsey, the Isle of Man or Jersey.

As previously noted, most UK closed-ended retail funds, as distinct from their managers, are outside FCA regulation, although their manager, or the fund itself if (unusually) self-managed, will be subject to FCA regulation (see question 16). A listed or exchange-traded closed-ended retail fund is subject to the governance requirements of the rules of the exchange on which it is listed or traded. In particular, the FCA's Listing Rules, applying to the LSE's Main Market, require that the majority of the fund's board of directors are independent of the investment manager.

21 What are the periodic reporting requirements for retail funds?

For UK open-ended retail funds, reports must be made available on request to investors and to the public generally, free of charge, annually and half-yearly. The reports must include certain prescribed information, including the accounts and, in the annual report, a report from the auditor and the trustee or depositary.

Closed-ended retail funds listed on the LSE's Main Market, or traded on its Specialist Fund Market or AIM, must also publish a report twice a year, with a long report annually. A closed-ended retail fund listed on the Main Market must also report to the UK tax authority (HMRC) annually in order to secure approval for favourable tax treatment (see questions 17 and 18) and make ongoing notifications to HMRC to maintain the approval.

22 Can the manager or operator place any restrictions on the issue, transfer and redemption of interests in retail funds?

UK open-ended retail funds must offer to issue and redeem (buy back) shares or units to or from investors on every dealing day. There must be at least two dealing days in each month, at least a fortnight apart. Retail funds can limit the number of shares or units in issue, provided this complies with the fund prospectus. Retail funds with a daily dealing day may defer redemptions to the next dealing day, if redemption requests for a particular day exceed 10 per cent of the fund's value, or some other reasonable proportion stated in the prospectus, subject to certain conditions. Dealing in open-ended retail funds may also be temporarily suspended under exceptional circumstances and where justified in the interests of unit or shareholders. This must be immediately notified to the FCA. A NURS can impose limited redemption arrangements (to limit redemptions for up to every six months) if it is a property fund, has an investment objective providing for a specified level of return (capital protection) or is a fund of alternative investment funds.

Shares in UK-listed or exchange-traded closed-ended retail funds are dealt in on-exchange. It will usually be a condition of listing or admission to trading, and of admission of the shares to a trade settlement system, that there are no restrictions on share transfer, although limited restrictions (such as on transfers to US persons) can be permitted. A UK closed-ended retail fund can repurchase its shares out of distributable profits, a method sometimes used to reduce a discount of the trading price to the fund's net asset (net investment) value.

Non-retail pooled funds

23 What are the main legal vehicles used to set up a non-retail fund? How are they formed?

Non-retail funds, other than limited partnerships, are typically established outside the UK, in an offshore jurisdiction, because there are no UK non-retail tax-exempt fund vehicles available, other than unauthorised unit trusts open only to UK tax-exempt unitholders.

In practice, closed-ended non-retail funds, such as private equity funds, are typically established as English or non-UK (offshore) limited partnerships and open-ended non-retail funds, such as hedge funds, as offshore open-ended companies or trusts. Scottish limited partnerships, which, unlike English limited partnerships, have separate legal personality, are occasionally used as non-retail fund vehicles (eg, for private equity 'carried interest' schemes, because they are closed-ended, but still tax-transparent). Commonly used offshore jurisdictions for non-retail limited partnerships are the Cayman Islands, Guernsey and Jersey and, for non-retail investment companies, the Cayman Islands and Ireland.

Exchange-listed closed-ended vehicles offered only to non-retail investors are typically formed in Guernsey or Jersey.

24 What are the key laws and other sets of rules that govern non-retail funds?

Non-retail funds are subject to the governing law of their jurisdiction of formation. Most offshore jurisdictions impose relatively light requirements on the establishment and operation of these vehicles, provided they are offered only to professional investors.

UK-based managers of non-retail funds are subject to UK law implementing the AIFMD, because they carry on the regulated activity of managing an AIF. The AIFMD requirements apply indirectly to an AIF, through imposing obligations on the AIFM (such as the appointment of a depositary). In addition, certain types of non-retail funds may qualify in the UK as a European venture capital fund or European social entrepreneurship fund under EU law applying to AIFMs. For example, sub-threshold AIFMs (see question 25) may obtain such a designation for a fund in order to allow it to be marketed to 'professional investors' (see question 26) throughout the EEA under an EU passport.

An AUT, OEIC or ACS may be established in the UK as a qualified investor scheme (QIS), a type of scheme authorised by the FCA available only to certain types of professional or experienced investor. In practice, because of this restriction, very few QISs have been established. As a QIS is not a UCITS, it will constitute an AIF under the AIFMD.

25 Must non-retail funds be authorised or licensed to be established or marketed in your jurisdiction?

A UK manager of a non-retail fund (wherever the fund is established) will have to be authorised under the FSMA – typically, as an AIFM, since the fund will be an AIF. UK AIFMs, unless 'sub-threshold' (see below), will be subject to the EU AIFMD for all purposes. The fund itself does not have to be (and cannot be) authorised or licensed, except in the specialised case of European long-term investment funds (ELTIFs), which must be authorised under the EU ELTIF Regulation. ELTIFs must be primarily invested in small companies and can allow investors only limited redemption rights. They can be marketed throughout the EEA, under an EU passport, to non-retail investors and (subject to conditions) also to retail investors.

Sub-threshold AIFMs are AIFMs whose aggregate AIF assets under management, across their entire portfolio, do not exceed €100 million or, where the funds are unleveraged and (for at least five years) closed-ended, €500 million. Sub-threshold AIFMs are not subject to the AIFMD (other than a limited registration regime), but are subject to

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FCA rules similar to those applying to discretionary investment managers that are not (directly) fund managers.

For marketing to non-retail ('professional') investors (see question 26), AIFs can be separated as follows (see further question 31):

- an EEA fund managed by a non-threshold EEA AIFM, which can be marketed throughout the EEA (including the UK) under an EU passport, subject to compliance with the AIFMD;
- a non-EEA fund managed by a non-threshold EEA AIFM, which can be marketed in the UK (but not throughout the EEA), following notification to the FCA, subject to compliance with the AIFMD;
- a fund managed by a non-EEA AIFM (including a sub-threshold non-EEA AIFM), whether the fund is established within or outside the EEA, which can be marketed in the UK, but not throughout the EEA, following notification to the FCA, subject to compliance with AIFMD (unless the AIFM is sub-threshold) transparency and ongoing regulatory reporting rules; and
- a fund managed by a sub-threshold EEA AIFM, which can be marketed in the UK, but not throughout the EEA, subject to compliance with the general UK financial promotion regime (see question 9).

26 Who can market non-retail funds? To whom can they be marketed?

Non-retail funds can be marketed in the UK by AIFMs (EEA (unless sub-threshold) or non-EEA) as set out in question 25 to professional investors (professional clients, within the meaning of MiFID II, including individuals (eg, investing through family offices) and local authorities satisfying the financial conditions to be treated as professional investors). In practice, it can be difficult for individuals and local authorities to satisfy these financial conditions. Separately, the UK financial promotion rules allow non-retail funds to be marketed to a number of other types of institutional and individual investor. In particular, non-retail funds can be marketed under those rules to local authorities and various classes of individual investor (such as certified sophisticated investors – see question 10), subject to conditions as to contents.

A person marketing a non-retail fund in the UK must be FCA-authorised if it:

- carries on a regulated activity in the course of marketing the fund, such as giving investment advice or arranging deals in investments; and
- carries on such activity in the UK, within the meaning of the FSMA (subject to the overseas person exclusion referred to in question 4).

In practice, UK intermediaries (eg, advising managers on UK marketing strategy or locating prospective UK investors) are normally FCA-authorised.

Brexit

Following the UK's referendum on continued membership of the EU in June 2016, the UK will leave the EU on 29 March 2019. There will, however, be a transitional period following the UK's exit, during which it is expected EU law existing at exit will continue to apply in the UK. It is not yet clear, though, whether EU law coming into effect in the EU after exit, but during the transitional period, will apply in the UK. Currently, the period is expected to last 21 months, ending on 31 December 2020. It is possible it may end on different dates for different EU financial services legislation, although, for practical reasons, this seems unlikely. At the end of the transitional period, the UK will be free to retain, amend or repeal EU legislation applying in the UK (whether directly or indirectly). The crucial point here is that, although EU-derived, this legislation will then apply only in the UK, rather than throughout the EEA, unless (but then only to the extent) any special (bespoke) EU–UK deal preserves its wider EEA ambit (eg, through an 'equivalence' regime for UK fund managers, allowing them 'market access' to the EEA, provided applicable UK regulation is 'equivalent' to EU regulation). Again, it is unclear whether any bespoke deals will in fact be concluded for the UK financial services industry, although the industry is pressing the UK government to negotiate, in particular, the continuation of EU passporting rights for UK managers (retail and non-retail) and for UK retail funds.

If there are no bespoke deals, the most important impact of EU exit, at the end of the transitional period, will be that UK financial services firms will lose these passporting rights, which currently allow them to:

- conduct 'cross-border' business throughout the EEA (including servicing clients in the EEA from the UK);
- establish branches throughout the EEA;
- sell UCITS and AIFs throughout the EEA; and
- access all EEA-regulated financial markets, central clearing counterparties and securities and derivatives clearing systems.

Also, without a bespoke deal, at the end of the transitional period, UK UCITS funds will automatically lose their 'UCITS' labels, and any delegation of investment management by EEA UCITS funds to UK managers will probably require a more substantial EEA (non-UK) administrative and governance presence than now, making this a less attractive option for EEA fund managers.

Following the referendum, the FCA stated that UK firms should continue with implementation plans for EU legislation that is not yet in effect, but is intended to be before EU exit.

27 Do investor-protection rules restrict ownership in non-retail funds to certain classes of investor?

There are no UK investor-protection rules restricting ownership of non-retail funds (including exchange-listed funds) to certain classes of investor. There are rules that limit the marketing in the UK of non-retail funds to certain classes of investor (see question 26), and certain types of investor, such as UK pension funds and UK charities, are subject to rules governing the types of investment they can make, for prudential or risk management reasons. In addition, FCA-authorised persons must ensure that any investment recommended to a client, whether retail or non-retail, is suitable for the client. There are also rules that apply to firms selling 'complex' financial products, including non-retail funds, on an execution-only basis to retail clients (ie, without giving advice) to ensure that any product sold is 'appropriate' for the purchasing client.

28 Are there any special requirements that apply to managers or operators of non-retail funds?

The FCA's rules (in particular, its FUND rules) contain rules, derived from the AIFMD, for AIFMs on (among other things) financial resources, risk and liquidity management, valuation, delegation, the appointment of a fund depositary, regulatory reporting, investor disclosure (transparency) and anti-'asset stripping'. These rules represent accepted international standards of best practice for managers, including hedge fund managers. The manager of a non-retail fund must also comply with any applicable locally derived rules of the jurisdiction in which the fund is established. For example, Ireland imposes rules on the governance and reporting required for funds established in Ireland.

29 What is the tax treatment of non-retail funds? Are any exemptions available?

Funds structured as partnerships are typically exempt from UK direct taxes. Broadly, then, partnership investors are taxed as if they had invested directly in the underlying partnership assets.

Funds structured as offshore companies are also typically not subject to UK direct taxes, provided that, where their activities would otherwise constitute trading in the UK for UK tax purposes (including through a dependent agent permanent establishment), the manager qualifies for the UK's 'investment management' tax exemption.

Under the UK offshore funds rules, UK-resident investors are generally subject to income tax on gains realised on the disposal of holdings in offshore companies, unless, very broadly, the fund is approved by HMRC as a 'reporting fund' and reports its income annually to UK investors and HMRC. If so, UK-resident investors pay capital gains tax on gains realised on their reporting fund holdings, but will have been subject to income tax (where applicable) on any income reported by that reporting fund (whether distributed or not). Special rules can apply to prevent 'double counting' in relation to the taxation of holdings in a reporting fund and special rules can treat distributions from bond funds (see question 18) broadly as if they were interest for tax purposes and require UK corporation tax payers to pay tax on bond fund holdings on an annual fair value basis.

30 Must the portfolio of assets of a non-retail fund be held by a separate local custodian? What regulations are in place to protect the fund's assets?

The AIFMD requires an EEA manager of an EEA AIF to appoint a depositary to hold the fund's assets, as the custodian, and to perform certain other oversight duties, such as monitoring the fund's cash accounts and its asset valuation process. An AIF depositary is liable for the loss of any of the fund's assets by itself, as custodian, or by a sub-custodian of

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any of the fund's assets (strict liability), unless it can prove that the loss arose as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts by it to the contrary. If the depositary carries on business in the UK, that business will also be subject to the FCA's CASS rules on custody of assets, designed to ensure that custodians observe professional standards of care and diligence, including in the appointment of sub-custodians.

An EEA manager of a non-EEA AIF not marketed in the EEA need not appoint a depositary. An EEA manager of a non-EEA AIF marketed in the EEA must appoint one or more entities to perform the depositary's custody and monitoring functions ('depositary-lite' functions), but the strict liability custody rule will not apply.

31 What are the main governance requirements for a non-retail fund formed in your jurisdiction?

The UK manager of a non-retail UK fund (a UK AIF) must be authorised by the FCA as an AIFM. A UK AIFM (unless sub-threshold) must apply to the FCA for approval to market a UK (or EEA non-UK) AIF in the UK and provide details of the AIF and a copy of its prospectus to the FCA. The FCA then has 20 working days in which to grant or refuse permission to the AIFM to market the AIF.

A UK AIFM (unless sub-threshold) must notify the FCA prior to marketing a non-EEA AIF in the UK and provide prescribed information. It may market the AIF following the notification (although, in practice, it will wait for acknowledgement of the notification from the FCA, which typically takes a day or so).

A UK AIF is not itself subject to organisational rules, although its manager (the AIFM) is subject to such rules (see question 28). The AIFM must disclose information regarding the AIF to investors on a periodic basis (see question 32).

32 What are the periodic reporting requirements for non-retail funds?

A UK AIFM (unless sub-threshold) must, for each EEA AIF it manages and for each AIF (wherever established) it markets in the EEA:

- prepare an annual report. The report must contain the fund's financial statements and disclose, for example, the total remuneration paid by the AIFM to its staff, split into fixed and variable amounts, and also the total remuneration paid to its senior management and staff members whose actions materially impact the particular AIF's risk profile;
- disclose information regarding the AIF (such as changes in liquidity, leverage or risk profile) to the AIF's investors on a periodic basis; and
- regularly report to the FCA on, among other things, the AIF's principal exposures, risk profile and asset categories (Annex IV reporting).

Separately managed accounts

33 How are separately managed accounts typically structured in your jurisdiction?

A UK separately managed (segregated) account is typically structured by the client appointing a custodian to hold its investments in the account, under a custody agreement, and giving an investment manager full discretion to acquire and dispose of the investments in the account, under a separate investment management agreement (IMA) (see question 34), subject to the investment objectives and restrictions set out in the IMA.

34 What are the key legal issues to be determined when structuring a separately managed account?

The terms for a separately managed UK account are typically set out in an IMA between the investor and manager. Often, this is a heavily negotiated document. An investor will seek, in particular, to negotiate terms relating to:

- the manager's fees, including any performance fee;
- the standard of care required of the manager (eg, reasonable care (avoidance of negligence) or only the avoidance of gross negligence);
- any limitation of the manager's liability (eg, to the value of the assets under management);
- any indemnity granted by the manager to the client (eg, if the manager breaches its standard of care) or by the client to the manager (eg, provided the manager acts within its authority); and
- the term (duration) and termination of the agreement.

FCA rules relating to, for example, best execution, aggregation and allocation of client orders, record-keeping, outsourcing, risk management and conflicts of interest, will apply to the manager.

Update and trends

The most significant known future event for the UK fund management industry as a whole is undoubtedly Brexit, discussed further in questions 26, 36 and 39. Both the likely regulatory and economic consequences for UK fund managers (whether or not UK-domiciled) can currently most accurately be described as speculative. The 'fog' is likely (but not by no means certain) to clear over the coming year.

For the clients of commodity derivatives fund managers, commodity derivatives position limits on EEA exchanges and in 'economically equivalent' off-exchange contracts are progressively being introduced (for the first time) by EEA national regulators, including the FCA, according to formulae and rules prescribed under MiFID II, following its implementation on 3 January 2018.

For all EEA investment firms (including UK fund managers), the European Commission is proposing new capital adequacy requirements. If adopted by the EU, these are likely to apply from some time in 2020 (no date has yet been fixed, since the legislation is still pending). They would be more risk-oriented than the current rules, and would be expected to result in some increase in the capital required for most fund managers.

Cryptocurrencies are currently generating much debate in the UK. UK UCITS funds are not permitted to invest in cryptocurrencies (directly or indirectly), but UK non-retail funds and UK segregated accounts are free to do so (directly or indirectly), if and to the extent permitted by the investment restrictions and objectives set out in their fund rules or IMAs and any legal restrictions relating to their clients, such as those applying to pension funds and charities. In practice, though, permission, even if available, is currently most unlikely to be utilised.

35 Is the management or marketing of separately managed accounts regulated in your jurisdiction?

Management of a separately managed UK account will constitute the regulated activity of managing investments, and require authorisation by the FCA.

A separately managed UK account is unlikely to constitute an AIF. Marketing a separately managed account in the UK is subject to the UK general financial promotion regime (see question 9). Broadly, a non-FCA-authorised person can market a separately managed account in the UK only to professional investors, local authorities, high net worth companies, high value trusts (such as private sector pension funds) and certified sophisticated or individual investors. An FCA-authorised person can market a separately managed account in the UK to any investor, subject to complying with the FCA's suitability and investor communication rules (eg, requiring the communication to be fair, clear and not misleading).

General

36 Are there proposals for further regulation of funds, fund managers or marketers of funds in your jurisdiction?

For the impact of Brexit on the UK fund management industry, see 'Brexit' in question 26.

Regarding the AIFMD, the European Commission is currently assessing whether to extend the AIFMD EEA-wide marketing passport to non-EEA AIFMs, and to EEA AIFMs marketing non-EEA AIFs to AIFMs or AIFs from specified non-EEA states (third countries), on the basis of those countries' deemed compliance with the AIFMD. The (supervisory) EU European Securities and Markets Authority (ESMA) issued its final advice to the European Commission in July 2016 on the extension of the passport to third countries, confirming there were no significant obstacles to the grant of the passport in relation to AIFMs and AIFs established in Canada, Guernsey, Japan, Jersey and Switzerland,

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and giving qualified advice in relation to Australia, Bermuda, the Cayman Islands, Hong Kong, the Isle of Man and the United States (noting aspects of those regimes that must change prior to granting the passport). Since receiving this advice, the European Commission has not taken any further substantive steps on the extension of the passport to third-country AIFMs and AIFs. It is currently not clear whether or, if so, when, it will do so. Brexit complicates the issue, since, from the end of the transitional period (see 'Brexit' in question 26), the UK will itself become a 'third' (non-EEA), non-passported, country, unless a bespoke EU–UK deal allows the UK's AIFMD passport to continue as now, or in some modified form. The AIFMD also envisages ESMA issuing advice to the European Commission on the termination of EEA states' current (non-AIFMD) national private placement regimes for non-EEA AIFMs and EEA AIFMs managing non-EEA AIFs (see question 7). No such advice has yet been issued, and it is not clear when (or whether) it will be.

In addition, in March 2018, the European Commission proposed further harmonisation of the implementation of the AIFMD in EEA states. In particular, it suggested a wider interpretation of 'marketing' an AIF (see question 8). If adopted while the UK is still subject to EU law (see 'Brexit' in question 26), this would significantly advance the time at which marketing in the UK of non-EEA AIFs, and by non-EEA AIFMs, would have to be notified to the FCA (see question 25).

37 Outline any specific requirements for stock-exchange listing of retail and non-retail funds.

See questions 12 to 22 regarding the stock-exchange listing, and trading, of closed-ended funds in the UK. Most closed-ended funds listed on the LSE's Main Market will be AIFs, although their listed status will allow them to be distributed to retail investors (if desired). Many (open-ended) UCITS exchange-traded funds are now also listed on the LSE's Main Market.

38 Is it possible to redomicile an overseas vehicle in your jurisdiction?

It is not possible to redomicile an overseas fund into the UK. It is, though, possible to put in place a scheme of arrangement, whereby an overseas fund is liquidated and investors receive interests instead in a UK fund, depending on the local non-UK law governing the overseas fund.

39 Are there any special rules relating to the ability of foreign investors to invest in funds established or managed in your jurisdiction or domestic investors to invest in funds established or managed abroad?

Other than the marketing restrictions referred to in question 7, there are no special rules in this regard.

While the UK remains a member of the EU (see 'Brexit' in question 26), EU law will prohibit the introduction of any such rules if they prevent citizens of other EEA states investing in the UK or UK citizens investing in other EEA states.

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