CHAMBERS GLOBAL PRACTICE GUIDES

Alternative Funds 2022

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UK: Law & Practice

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UK

Law and Practice

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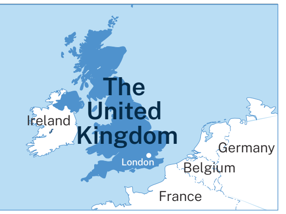

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1. General

1.1 General Overview of Jurisdiction

The UK is the largest asset management centre in Europe and is second only to the USA globally; within Europe, it is especially dominant in the hedge fund market, for both managers and investors.

The UK is home to alternative asset managers and investors in every sector, including asset allocators and other advisers representing investors from all over the world, and provides a welcoming and sophisticated regulatory, tax and business environment from which to manage or invest in alternative funds.

The UK has a wide range of fund vehicles, both open- and closed-ended, available to both domestic and international investors. However, UK managers typically establish hedge funds in other jurisdictions (most commonly, the Cayman Islands). Similarly, many private equity funds will be established elsewhere (eg, the Cayman Islands, Jersey or Luxembourg). UK funds may be used for an international market, but are more often for a domestic market.

However, in April 2022, the UK introduced a new form of tax-advantaged asset holding vehicle: the qualifying asset holding company (QAHC). The QAHC is intended to provide a UK alternative to asset holding vehicles in other jurisdictions, such as the Luxembourg SARL and the Irish Section 110 company, and should be able to utilise the UK's wide range of double-tax treaties to reduce source-country withholding taxes on its income and gains. The QAHC may be a suitable vehicle to hold assets in appropriate circumstances, whatever the location of the fund or manager.

2. Funds

2.1 Types of Alternative Funds

A wide range of alternative funds can be established in the UK. True hedge funds are rare, but both open- and closed-ended funds may pursue hedge fund-type strategies. A significant number of private equity and other closed-ended funds are established in the UK.

Whilst certain alternative type strategies can be run within an authorised fund format (see **2.3 Funds: Regulatory Regime**), authorised funds (with the exception of LTAF – see below) are not generally considered suitable for many alternative strategies, given the requirement for at least bi-monthly liquidity and investment restrictions and concentration limits – especially in the case of undertakings for collective investment schemes (UCITS) and non-UCITS retail schemes (NURS).

A new category of authorised fund, the "long-term asset fund" (LTAF) was established in November 2021. LTAF is an authorised open-ended fund structure for investment in long-term and illiquid assets, such as venture capital, private equity, private debt, real estate and infrastructure.

2.2 Fund Structures

Open-ended funds can be established as investment companies with variable capital (ICVCs, also known as OEICs), unit trusts (AUTs) or contractual schemes (ACS). ICVCs are the most common vehicles for funds that are to be widely marketed, especially outside the UK.

ACS are designed to be tax-transparent and can be established as either a co-ownership scheme or a limited partnership scheme. In regulatory terms, they are established as a UCITS, NURS, qualified investor scheme (QIS) or LTAF.

Private equity, venture capital, real estate and infrastructure funds are typically established as limited partnerships and can be registered as private fund limited partnerships (PFLPs). PFLPs are subject to reduced administrative requirements compared to other limited partnerships, and benefit from other features designed to make them more attractive as investment vehicles – for example, limited partners can take certain actions without risking their limited liability and PFLPs are not subject to capital rules, which historically meant that capital contributions to limited partnerships were structured as loans. Most new funds established as limited partnerships are registered as PFLPs. It is possible to convert an existing fund into a PFLP.

Listed companies (called "investment trusts" and registered as such) can be used for both liquid and illiquid investment strategies. These are primarily for the domestic market.

2.3 Funds: Regulatory Regime

Different regimes apply to different types of funds.

Open-Ended Funds

Open-ended funds in the UK can be established under the "onshored" EU regime for UCITS, or as LTAF, NURS or QIS. In each case, authorisation of the fund by the Financial Conduct Authority (FCA) is required. UK open-ended funds may not be established as unregulated funds. The fund authorisation is separate to the authorisation requirements applicable to investment managers of such funds.

UCITS, LTAF, NURS and QIS funds are referred to as "authorised funds". UCITS and NURS can be sold to retail investors (ie, those that do not meet the "professional investor" test) and are subject to similar rules and investment restrictions. Additional investor protection safeguards (such as risk warnings and an "appropriateness" assessment) also apply when offering LTAF to retail investors. QIS are designed for more experienced investors who meet certain qualifying conditions.

Authorised funds can be structured as umbrella funds with multiple sub-funds. NURS and QIS can operate as "funds of alternative investment funds" (FAIFs).

The instrument constituting the fund and its prospectus will normally specify the applicable investment restrictions (within the confines of the regulatory requirements). The manager of an authorised fund is responsible for ensuring that the property of the fund provides a prudent spread of risk, taking into account the investment objectives and policy of the fund as stated in the most recently published prospectus.

Eligible assets

UCITS and NURS are subject to prescriptive rules on "eligible assets", including that investments are admitted to trading on "eligible markets" (eg, EEA exchanges or other regulated trading venues meeting certain conditions), limitations on borrowing, use of derivatives, counterparty risk and concentration limits. These rules, set out in the FCA's COLL Sourcebook, are intended to provide diversification, limit leverage and manage risk. Maximum limits are set for various classes of eligible investment assets, such as transferable securities (shares, debentures, government and public securities, and warrants and certificates representing certain securities), approved money market instruments, units or shares in other funds, derivatives and forward transactions and deposits. For example, a UCITS fund may not invest more than 5% of its assets in transferable securities or money market instruments issued by a single body, although this limit can be increased to 10% per single body if the total value of such holdings over 5% does not exceed 40% of the total value of the fund; this is the "5/10/40 rule". Additionally, UCITS funds may not invest in commodities, nor have direct holdings in real property.

NURS can invest in a wider range of eligible investments (including real estate) and are subject to slightly less restrictive borrowing rules than UCITS. For NURS that operate as FAIFs, the rules regarding investment and borrowing powers are more relaxed regarding the types of collective investment schemes in which they may invest, subject to prescriptive due diligence requirements in respect of such investments.

LTAF must invest mainly in assets that are long-term and illiquid in nature (such as illiquid securities – listed or unlisted – or real estate), or in other funds (including overseas funds) that invest in such assets.

Portfolio management

UCITS may use derivatives for "efficient portfolio management" (eg, hedging, reducing costs or generating additional capital or income, subject to conditions) and investment purposes, in the case of both exchange-traded derivatives (provided that eligible market conditions are met) and over-the-counter (OTC) derivatives. The maximum permitted exposure to any one counterparty in an OTC derivative transaction must not exceed 5% of the total value of the fund's assets, although this limit is increased to 10% where the counterparty is an approved bank.

Global exposure relating to derivatives and forward transactions must not exceed the net value of the scheme property. It must be calculated on a daily basis, taking into account the current value of the underlying assets, counterparty risk, future market movements and the time available to liquidate the positions. UCITS managers are required to employ a risk management process to monitor and measure, at any time, the risk of positions and their contribution to the overall risk profile of the portfolio. Managers of funds using derivatives as a fundamental part of their investment objective, engaging in complex investment strategies or exposed to exotic derivatives must use an advanced risk measurement methodology (supported by a stress testing programme) such as the Value-at-Risk (VaR) approach to calculate global exposure.

NURS are subject to less restrictive conditions regarding investment in derivatives, but the maximum permitted exposure for a NURS to any one counterparty in an OTC derivative transaction is set at 10% of the fund's assets.

LTAF and QIS are subject to a general requirement for prudent spread of risk, certain restrictions on borrowing and limited conditions applicable to eligible investments, but are not subject to prescriptive counterparty and concentration limits.

Closed-Ended Funds

Closed-ended funds established in the UK (including funds structured as English or Scottish limited partnerships, or listed investment trusts) do not require FCA authorisation and are not subject to regulatory investment restrictions. Rather, investment limitations are self-imposed in order to meet investor expectations and requirements. These funds may also be subject to other requirements in order to meet their tax status.

Alternative Investment Funds Regime

LTAF, NURS, QIS and unregulated closed-ended funds are classified as "alternative investment funds" (AIFs) and fall under the regulatory regime established by the EU Alternative Investment Fund Managers Directive (AIFMD). This regime, found in the FCA's FUND Sourcebook, sets out certain organisational and operating conditions (such as risk management, liquidity management, responsibility for valuation and leverage policy requirements) applicable to alternative investment fund managers of these funds (AIFMs), and investor protection obligations (eg, conflicts of interest, investor disclosure and reporting). No immediate material changes to the AIF rules are expected following Brexit, apart from some future relaxation of certain mandatory investor disclosure obligations imposed under the EU legislation.

UCITS management companies and AIFMs investing on behalf of their funds are prohibited from investing in securitisation exposures (eg, collateralised loan obligations) unless the risk retention requirements established under the EU Securitisation Regulation (which has been "onshored" in the UK following Brexit) have been satisfied. Additional restrictions apply to AIFMs acquiring controlling stakes in companies established in the UK (see **4.5 Investors: Regulatory Regime**).

2.4 Loan Origination

Direct lending to UK commercial enterprises may be undertaken by a non-bank entity – eg, an alternative investment fund. Consumer lending and loan servicing generally require authorisation by the FCA (the licensing requirements would normally apply both to the fund, as the lender of record, and to the investment manager or another party that undertakes consumer loan servicing/debt collection activities).

For UK tax purposes, investments of a fund that arise from direct lending are generally treated in the same way as other interest-bearing investments (so that such investments are, for example, "qualifying investments" for the purposes of the "bond fund" regime applicable to AUTs/OEICS).

2.5 Non-traditional Assets

Authorised funds are subject to eligible assets restrictions and cannot invest in cryptocurrencies or similar assets.

There are no restrictions on unregulated funds investing in digital assets, cannabis-based or psychedelic-based therapeutics, or other types of alternative assets. The main factors limiting investments in such assets have been the scarcity of service providers capable of acting as custodians, or AIFMD "depositaries", for such assets, and money laundering concerns in the case of certain types of digital assets and investments in companies that manufacture or distribute recreational drugs.

2.6 Regulatory Approval Process

Authorised fund applications involve an assessment of the fund structure (ACS, AUT or OEIC), scheme documents (ie, trust deed or instrument of incorporation (as applicable), prospectus, Key Information Document (KID), etc), its investment strategy and risks, and whether the fund is suitable for the target investor groups. An FCA case officer will review the application and contact the applicant with any comments or to ask for further information or clarification. Applications typically take two months for UCITS, and up to six months for LTAF, NURS and QIS. An authorised fund will appear on the Financial Services Register.

2.7 Requirement for Local Investment Managers

Management companies of UK UCITS funds must be authorised by the FCA as UCITS management companies.

UK managers of LTAF, NURS and QIS must be authorised by the FCA as AIFMs to manage authorised alternative investment funds.

Unregulated UK funds do not require a UK manager. However, self-managed closed-ended funds (ie, funds that do not appoint an external manager) require authorisation by the FCA. Investment managers that manage funds (established in either the UK or another jurisdiction) from an establishment, or a place of business, of such manager in the UK must be authorised by the FCA.

2.8 Other Local Requirements

A UK OEIC must have a UK-authorised corporate director. It may also have other directors, but this is not required.

A unit trust (authorised or unauthorised) will need a UK trustee.

An English general partner is, in practice, required to form an English limited partnership but it could subsequently be substituted with another (non-English) general partner.

Although it does not stipulate residence requirements, the UK Listing Authority requires the board of directors of an investment trust (which is a company despite its name) to be able to demonstrate its independence in practice from the investment manager, and a majority must be independent of the investment manager and its professional advisers.

2.9 Rules Concerning Other Service Providers

Authorised funds and unregulated funds established in the UK and managed by a UK AIFM must appoint a regulated depositary established in the UK.

The depositary has general oversight responsibilities for the manager's activities, including with respect to unit pricing, dealing, portfolio valuation and adherence to investment policy and restrictions, and is responsible for safeguarding the fund's assets.

2.10 Requirements for Non-local Service Providers

Service providers to UK funds that are not themselves operating from a place of business in the UK are not subject to UK registration or regulation. As noted, the depositary of a UK AIF must be established in the UK (by having either a registered office in the UK or a branch). See **2.7 Requirement for Local Investment Managers**.

2.11 Funds: Tax Regime

It is a general principle of the UK tax regime applicable to investment funds that investors should, so far as possible, be placed in the same tax position as if they had invested directly in the underlying assets. This is achieved in a variety of ways, depending on the nature of the particular fund entity under consideration.

Limited Partnerships (Not ACS)

Closed-ended funds established as English limited partnerships (not ACS), such as private equity funds, venture capital funds and some real estate funds, are tax transparent for UK tax purposes in respect of both income and capital gains. Limited partners (the investors) are treated as having a direct ownership interest in all of the assets (and the underlying income and gains) of the limited partnership in proportion to their respective interests in the limited partnership. Consequently, the limited partnership is not chargeable to income, capital gains or corporation tax, but, instead, each limited partner is potentially liable to UK tax on its share of the income and capital gains according to its own particular UK tax status. Where the limited partnership holds UK real property (either directly or indirectly through the holding of interests in an entity that is a "UK-property rich" entity), the UK's regime for the taxation of gains realised by non-UK residents on disposals of interests in UK real property means that non-UK resident limited partners are liable to UK tax on their share of gains realised on the disposal of such assets.

English limited partnerships are, in principle, liable to UK VAT on their receipt of management services. To address this, the limited partnership could have a general partner located outside the UK, or it is common for the general partner to be a member of a VAT group that also includes the manager providing those services (so that, in either case, the management services are treated as being "outside the scope" of VAT and VAT is not chargeable). The same VAT treatment will be applicable regardless of whether the manager receives its management fee directly from the limited partnership or from the general partner (with the general partner being put in funds to pay the management fee by a priority profit share received by the general partner from the limited partnership).

AUTs and OEICs

AUTs and OEICs are generally treated as if they are UK tax resident companies and as if the rights of the investors in relation to the AUT/OEIC are shares in that company. Consequently, AUTs/OEICs are, in principle, chargeable to corporation tax on their worldwide income and gains, but they benefit from an exemption from tax on chargeable gains. AUTs/OEICs meeting a "genuine diversity of ownership" condition and adopting appropriate accounting treatment benefit from a "white list" of specified transactions – including transactions in derivative contracts, options and transactions that give rise to a creditor loan relationship – under which such transactions are treated as investment and not trading transactions, and therefore generate chargeable gains on which the AUT/OEIC is exempt from tax.

AUTs/OEICs generally qualify for the wider exemptions available to all UK corporation tax payers on dividends, but remain subject to corporation tax on all other income, such as:

- property income dividends from REITs or property authorised investment funds (PAIFs);
- income from trading transactions (subject to the application of the "white list" so as to treat transactions in certain specified assets as non-trading transactions);
- interest income (although an AUT/OEIC within the bond fund regime has the ability to generate an offsetting deduction against its interest income by an interest distribution); and
- offshore income gains arising from the disposal of interests in certain non-reporting offshore funds (broadly being non-reporting offshore funds where the AUT/OEIC is not able to obtain sufficient information about the non-reporting offshore fund to determine its share of the "reportable income" of the non-reporting offshore fund), unless the AUT/OEIC has entered the FINROF regime (funds investing in non-reporting offshore funds – see **FAIFs/FINROF** below).

Under the bond fund regime, an AUT/OEIC that meets a "qualifying investments" test where 60% or more by market value of the AUT/OEIC's assets throughout a distribution period comprise money placed at interest (including by way of direct lending), securities, building society shares, units in another investment fund that is itself a bond fund, certain derivative contracts and alternative finance arrangements can treat its dividend distributions as deductible expenses in calculating its corporation tax liability. In most cases, this enables the AUT/OEIC to create a full offsetting deductible expense for its taxable interest income.

Dividend distributions from AUTs/OEICs are not subject to withholding tax (unless the AUT/OEIC is a PAIF – see **Property Authorised Investment Funds** below).

AUTs/OEICs qualify for a VAT exemption for the management of "special investment funds" and hence are not required to pay VAT on the fees that they pay for management services.

Authorised Contractual Schemes

ACS may take the form of either limited partnerships or co-ownership schemes.

ACS that are limited partnerships are treated for tax purposes in the same manner as limited partnerships that are not ACS. The ACS is tax-transparent as to income and chargeable gains, and the investors are treated as if they had invested directly in the underlying assets (and directly received the income and gains flowing from them) of the ACS.

An ACS that is a co-ownership scheme is transparent for income tax purposes, but is opaque for the purposes of capital gains tax and corporation tax on chargeable gains. Consequently, the asset held by an investor in a co-ownership ACS is its units in the ACS, and the investor is not treated as having an interest in the underlying assets of the ACS. The ACS is not subject to chargeable gains taxation on disposals of its assets, and investors will realise a taxable chargeable gain (or loss) upon the disposal or redemption of their units in the ACS.

ACS qualify for a VAT exemption for the management of "special investment funds" and hence are not required to pay VAT on the fees that they pay for management services.

Property Authorised Investment Funds

OEICs that carry on a property investment business (which may comprise a property rental business or the holding of shares in UK REITs or shares or units in certain listed overseas UK-REIT equivalents) may elect to become PAIFs, by notification to HMRC. In order for the PAIF regime to apply, an OEIC must meet six conditions, including a "genuine diversity of ownership" condition and a requirement to take "reasonable steps" to prevent investors that are companies from acquiring a beneficial interest of 10% or more in the net asset value of the OEIC.

In addition to the general tax exemptions on chargeable gains and dividend income that are available to all OEICs, a PAIF is exempt from corporation tax on its income derived from its property investment business (including rental income from the PAIF's property rental business and distributions from UK REITs or their overseas equivalents).

Depending on the nature of its underlying income, a PAIF may make one or more of the following three kinds of distribution:

- property income distributions out of income attributable to their property investment business;
- interest distributions; and
- dividend distributions.

An interest distribution is a deductible expense for the PAIF against the income of its non-tax-exempt business. Property income distributions paid by a PAIF from its tax-exempt property investment business are subject to withholding tax unless an exemption applies (such as where the PAIF reasonably believes that the recipient of the property income distribution is subject to corporation tax on the distribution).

Like all OEICs, PAIFs qualify for a VAT exemption for the management of "special investment funds" and hence are not required to pay VAT on the fees that they pay for management services.

UK REITs

The tax treatment applicable to UK REITs is broadly similar to that which applies to PAIFs. UK REITs are tax-opaque and are, in principle, chargeable to corporation tax, but are exempt from tax on all income and gains derived from their UK property rental business. To be eligible for the UK REIT regime, a company must meet various conditions, including:

- either its ordinary share capital is admitted to trading on a recognised stock exchange or (with effect from 1 April 2022) at least 70% of its ordinary share capital is owned (directly or indirectly) by specified "institutional investors";
- at least 75% of profits come from its property rental business and 75% of the total value of its assets is from assets held for the purposes of its property rental business; and
- it must take reasonable steps to ensure that no single corporate shareholder holds more than 10% of its share capital.

In addition, a UK REIT must distribute at least 90% of its profits attributable to its property rental business.

Like PAIFs, UK REITs distribute income and gains attributable to their property rental business by way of property income distributions (PIDs), from which the UK REIT must withhold income tax, unless an exemption applies, such as a reasonable belief on the part of the UK REIT that the recipient of the PID is subject to corporation tax on the receipt.

UK REITs are subject to VAT on management fees charged to them by external managers, but depending on the precise circumstances it may be possible to mitigate this charge by, for example, including the UK REIT and its manager in a VAT group.

FAIFs/FINROF

AUTs/OEICs that are FAIFs for regulatory purposes may choose to enter the FINROF tax regime.

AUTs/OEICs that invest in non-reporting offshore funds (and cannot obtain sufficient information about their share of the "reportable income" of the non-reporting offshore fund to treat it as if it were a reporting fund) are chargeable to UK corporation tax on gains they realise on the disposal of their interests in those non-reporting offshore funds, unless they enter into the FINROF tax regime.

However, if more than 50% of the AUT/OEIC's assets consist of interests in such non-reporting offshore funds, the AUT/OEIC may make an election to enter the FINROF regime. Under that regime, the AUT/OEIC is not chargeable to corporation tax on gains it realises on a disposal of its interest in a non-reporting offshore fund, but instead a UK resident investor is taxed on any gain arising on the disposal of its interest in the AUT/OEIC as if that gain were income. The net effect of the FINROF regime for AUTs/OEICs that invest substantially in non-reporting offshore funds is to shift the tax charge from the AUT/OEIC itself to the investors in the AUT/OEIC, and to apply to those investors broadly the same tax treatment as if they had invested directly in the underlying non-reporting offshore fund.

UK Investment Trusts

An investment trust is typically a UK public company listed on a recognised stock exchange for the purposes of investing in shares of other companies or other investment assets. Such a company may seek approval from HMRC to become an approved investment trust. HMRC will grant approval if the company meets certain ongoing eligibility conditions, including a requirement that all or substantially all of the business of the company consists in investing its funds in shares, land or other assets with the aim of spreading investment risk. On an ongoing basis, the company must not be a "close" company for UK tax purposes and must distribute at least 85% of its income for each accounting period.

The tax regime that applies to approved investment trusts is broadly similar to that which applies to AUTs/OEICs. Approved investment trusts are subject to corporation tax, but benefit from an exemption on chargeable gains (including profits arising from their derivative contracts and creditor loan relationships where these are treated, on the basis of an appropriate accounting treatment, as being capital in nature, and gains arising from transactions in assets that appear on the "white list").

Approved investment trusts are able to treat certain distributions to their shareholders as deductible interest, and not dividend distributions, thereby creating an offsetting deduction to reduce any corporation tax charge on what would otherwise be their taxable income.

Approved investment trusts qualify for a VAT exemption for the management of "special investment funds" and hence are not required to pay VAT on the fees that they pay for management services.

LTAF

HMRC has issued regulations (the Authorised Investment Funds (Tax) (Amendment) Regulations 2021, SI 2021/1270) confirming that LTAF – which can be established as OEICs, AUTs or ACS – will be taxed in the same way as other authorised funds of the relevant legal character. An LTAF established as an OEIC or an AUT needs to meet a "genuine diversity of ownership" test – broadly requiring at least 70% ownership by specified "institutional investors" – to qualify for the beneficial tax treatment of such authorised funds.

2.12 Double-Tax Treaties

Funds established as limited partnerships are tax-transparent and, therefore, are not able to take advantage of double-tax treaties. However, depending on their particular tax status and the terms of the relevant treaty, investors in these funds may be able to take advantage of a double-tax treaty in respect of allocations of income and gains they receive from the fund. Some investors may request the fund to provide them with detailed information about the character and sources of individual items of income and gain in the fund in which the investor participates, to identify the relevant double-tax treaty and to make their own applications for double-tax treaty benefits in respect of the relevant income and gains.

Depending upon the terms of the relevant treaty, tax-opaque UK funds such as AUTs/OEICs and approved investment trusts may be able to take advantage of a double-tax treaty to reduce or eliminate foreign withholding taxes that would otherwise be levied upon income received by the fund, such as interest or dividend income.

Distributions from UK funds are generally not subject to UK withholding taxes. However, where the UK does levy a withholding tax, a non-UK investor may be able to rely upon a double-tax treaty to reduce or eliminate this withholding tax, depending upon the terms of the applicable treaty and the particular tax position of the non-UK investor.

2.13 Use of Subsidiaries for Investment Purposes

It is not common for UK-based tax-opaque funds to use investment subsidiaries. The UK has one of the most extensive networks of double-tax treaties in the world, and UK-based tax-opaque funds are generally able to rely upon those double-tax treaties to reduce or eliminate foreign withholding taxes.

In the case of tax-transparent funds such as limited partnerships, managers generally agree to provide information and otherwise facilitate the making of double-tax treaty relief claims by investors in their own jurisdictions (see **2.12 Double-Tax Treaties**), rather than interposing treaty subsidiaries to hold investments of the fund. However, since April 2022, it has been possible (subject to meeting certain eligibility conditions) to establish a new kind of UK investment-holding entity, the qualifying asset holding company (QAHC), which is entitled to beneficial UK tax treatment and should also be able to take advantage of the UK's double-tax treaties to reduce or eliminate withholding taxes on source-country income and gains. In the future, managers of tax-transparent funds may choose to hold investments through a QAHC in order to access those treaty benefits, as an alternative to requiring investors to make double-tax treaty benefit claims in their own jurisdictions.

The QAHC is intended to provide a UK alternative to broadly tax-neutral asset holding vehicles in other countries, such as the Luxembourg SARL and the Irish Section 110 company, and can be used regardless of the location of the fund or manager. For some funds, in particular those utilising credit-based strategies, the fact that the QAHC is not subject to the interest-restriction provisions of the EU Anti-Tax Avoidance Directives may make the QAHC a more straightforward asset holding vehicle than such equivalent vehicles in European countries.

In order to claim double-tax treaty benefits, however, the QAHC may need to demonstrate that it has sufficient "substance" in the UK – in terms of premises, staff and/or other UK physical presence – to be considered the genuine beneficial owner of its income and assets. UK managers, or non-UK managers with a UK office or other UK presence, are likely to find it easier to leverage this existing UK presence to demonstrate that a QAHC has the necessary "substance".

2.14 Origin of Promoters/Sponsors of Alternative Funds

UK managers are the promoters or sponsors of alternative funds established in many jurisdictions. UK alternative funds are generally established by UK manager, although they can be from other jurisdictions (see **2.7 Requirement for Local Investment Managers** and **2.8 Other Local Requirements**).

2.15 Origin of Investors in Alternative Funds

There are no restrictions on the domicile of investors in UK alternative funds (subject to sanctions regimes). Whilst UK alternative funds primarily attract UK investor interest, there are investors from many jurisdictions.

UK private equity, venture capital, real estate and infrastructure funds are commonly invested in by continental European, US and Asian investors.

2.16 Key Trends

Following Brexit, a relatively limited number of managers have established a presence in an EU jurisdiction, but expect to maintain the bulk of their investment operations in the UK. The advent of the ACS and the PFLP indicate the UK authorities' willingness to develop new products to maintain the position of the UK asset management sector, and asset management is recognised as being of vital importance to the UK economy.

Whilst it is not expected that UK regulation will significantly diverge from the existing structure or that the UK will adopt a lesser regulatory framework, the FCA has indicated that it might consider taking a different approach to certain matters, especially around the conduct of business or mandatory disclosure obligations.

2.17 Disclosure/Reporting Requirements

Both UCITS management companies and AIFMs are required to comply with detailed investor disclosure obligations.

Authorised Funds

The pre-investment disclosure obligations are specified in the FCA's COLL Sourcebook. The fund prospectus must contain sufficient details on:

- the fund's investment objectives and policy (including investment and borrowing restrictions, and eligible markets);
- the fund's operation, valuation and pricing policies;
- the persons responsible for operating the fund;
- all expenses that are deductible from the fund's assets; and
- any dilution levy/adjustments arrangements.

The manager must ensure that the prospectus is reviewed frequently and kept up to date. All current and potential investors must be able to obtain a copy of the prospectus on request, free of charge.

Authorised funds must produce semi-annual and annual reports. The prospectus, simplified disclosure document, and annual and semi-annual reports related to authorised funds are made publicly available. The application to UCITS funds of the requirement to produce a KID (see below), replacing the similar simplified disclosure document requirement under the UCITS Directive, has been delayed several times. Under the current proposals, the requirement to produce a KID may be suspended in the UK for up to five years following the end of the transitional period.

AIFs

Similar disclosure obligations apply to LTAF, NURS and QIS (which are also categorised as AIFs) under the rules that originate from the AIFMD, as well as the Securities Financing Transactions Regulation (SFTR). These disclosures do not have to be made in the fund's prospectus, although managers usually choose to include this information there.

Other funds categorised as AIFs that are either established in the UK or managed by a UK AIFM are subject to the mandatory pre-investment disclosures, as well as annual report requirements originating from the AIFMD. Annual financial statements included in such reports must be audited. The same disclosure and periodic reporting obligations also apply to non-UK funds managed by non-UK AIFMs as a condition for marketing under the UK private placement regime for AIFs (see **4.3 Rules Concerning Marketing of Alternative Funds**). Pre-investment disclosures and annual reports relating to such non-retail AIFs are not made public.

AIFs offered to retail investors, such as high net worth individuals (see **4.2 Marketing of Alternative Funds**), also require production of a KID – a short-form standardised disclosure document containing key information about the fund, the applicable risks and summary risk indicator, and fund expenses. These requirements apply under the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation.

2.18 Anticipated Changes

The EU regulatory regimes under the AIFMD and UCITS Directive in effect before Brexit have become a part of UK domestic law, subject to any future suspension of certain EU requirements. Certain elements of those regimes – such as the ability of EEA-authorised UCITS management companies to manage UK UCITS – are no longer in effect, subject to limited transitional arrangements. As a result, managers authorised in EEA countries are no longer eligible to manage UK authorised funds, subject to any transitional regime that may be in place.

3. Managers

3.1 Legal Structures Used by Fund Managers

UK alternative fund managers typically establish their management entities as limited companies or as limited liability partnerships (LLPs). There are different tax consequences to the use of these two types of business entity.

3.2 Managers: Regulatory Regime

Managing a UCITS or an AIF is a regulated activity in the UK. UCITS management companies and AIFMs require FCA authorisation under the regulatory regimes established under the UCITS Directive and the AIFMD, respectively.

A different regulatory regime applies to UK-based managers that only provide portfolio management services to UCITS funds or AIFs on a delegated basis. Such portfolio managers are also subject to authorisation by the FCA, but under the regulatory regime established by the revised EU Markets in Financial Instruments Directive (MiFID II). Similar domestic regulatory regimes apply to managers that manage small AIFs (those below thresholds set by the AIFMD – ie, AIFMs that manage in aggregate open-ended funds with assets not exceeding EUR100 million, including any assets acquired through use of leverage) or closed-ended funds that are unleveraged and have no redemption rights for five years with assets not exceeding EUR500 million.

Requirements

The regulatory regime applicable to UK managers contains a number of elements, including:

- financial resources requirements (ie, minimum regulatory capital);
- periodic reporting obligations to the FCA;

- obligations to notify certain events (such as change in control or material developments) to the FCA;
- requirements to maintain sufficiently qualified staff and other internal governance and organisational requirements; and
- requirements to maintain appropriate policies and procedures to comply with the requirements of the FCA rules and other applicable law (eg, conflicts of interest, personal account dealing, financial promotion, communications and reporting to clients, other conduct of business obligations and financial crime prevention).

Individuals performing certain roles within the UK manager require approval by the FCA.

UK alternative fund managers are subject to UK law and regulation on insider dealing, market abuse, short-selling, financial crime, such as money laundering, the prevention of terrorist financing and bribery, among other things.

3.3 Managers: Tax Regime

There is no special tax regime that applies to alternative fund managers in the UK. Managers typically establish their management companies as either limited companies or LLPs.

Limited Companies

Limited companies are tax-opaque and subject to corporation tax on their income and chargeable gains. In this case, individual managers will be shareholders and/or employees of the management company. UK tax resident individuals receiving dividends out of the post-corporation tax profits of the company are subject to UK dividend taxation at rates of up to 39.35%.

Alternatively, a limited company may pay employment compensation (deductible in the calculation of the company's corporation tax liability) in the form of a salary or bonus to individual managers. An individual receiving employment compensation is liable to income tax at rates of up to 45% and national insurance contributions at a rate of approximately 3.25%. However, a limited company employer also incurs a (corporation tax deductible) charge to employer's national insurance contributions of 15.05% of the amount of compensation paid to employees.

Limited Liability Partnerships

Where the management company is established as an LLP, certain individuals may become members (partners) and be compensated in the form of a share of the LLP's income and gains. Members of an LLP are treated as self-employed for tax purposes. The individuals remain liable to income tax at the effective 45% income tax rate and 3.25% national insurance contributions rate, but there is no 15.05% charge to employer's national insurance contributions on an allocation of income and gains to a member of an LLP.

There is, however, anti-avoidance legislation (the "salaried members" rules), which is designed to apply where the relationship between the LLP and a member is equivalent to an employment relationship, so that the member might be regarded as a "disguised employee". Where the salaried member rules apply, both the member and the LLP (the deemed employer) are liable to income tax and national insurance contributions as if the member had been an employee of the LLP.

Where a UK management entity acts as a discretionary investment manager for a non-UK tax resident fund or other person whose investment strategy amounts to the conduct of a trade for UK tax purposes, it may be necessary to ensure that the relationship between the non-resident and the UK manager meets the conditions of the "investment manager exemption" so as to avoid the non-resident becoming liable to UK tax (see **3.4 Rules Concerning Permanent Establishments**). This may limit the extent to which the UK manager or individuals associated with the UK manager can hold ownership interests in the funds managed by the UK manager.

3.4 Rules Concerning Permanent Establishments

Funds that are AIFs for regulatory purposes are generally able to take advantage of a statutory exemption that causes them to be treated as not resident in the UK for UK direct tax purposes.

Non-UK tax resident funds that are not trading for UK tax purposes, but are engaged in investment activity, are not subject to UK tax on profits arising from that investment activity (other than under the special regime for the taxation of gains realised by non-UK residents on disposals of interests in UK real property), even with a UK investment manager to carry on that investment activity as the fund's agent. Whether a non-UK tax resident fund is trading or investing is determined by the application to the facts of a number of "badges of trade" identified in UK case law. The most relevant considerations are often:

- the motive in acquiring a position;
- the average length of holding period of assets in the portfolio; and
- the degree of frequency with which the portfolio is turned over.

These tests can be difficult to apply in certain contexts, but HMRC has indicated in its published guidance that the active management of a portfolio of assets will generally be regarded as investment and not trading activity. Where a non-UK tax resident fund adopts a "master/feeder" structure, under which the activities of a feeder fund are confined to the holding of ownership interests in a tax-opaque master fund, the feeder would generally be treated as investing and not trading for these purposes. Whether or not the master fund is trading must be determined by applying the badges of trade to its activities.

Funds that are non-UK tax resident but whose activities include the carrying on of a trade in the UK (including a trade carried on by a UK investment manager as the fund's agent) are, in principle, liable to UK tax on their profits arising from trading transactions undertaken or initiated on their behalf by the UK manager. However, funds that are trading through a UK investment manager are generally able to take advantage of a statutory exemption (the "investment manager exemption") from UK taxation on those UK trading profits. These conditions include:

- an "independent capacity" condition, designed to ensure that the relationship between fund and manager is equivalent to that between independent parties dealing with each other at arm's length;
- a "20% test", designed to limit the percentage interest which a UK investment manager or persons connected to it may hold in the funds which it manages; and
- a "customary rate of remuneration" test, designed to ensure that the fees paid by the non-resident fund to the UK manager are not less than is "customary" for the type of business which the UK manager is carrying on, on behalf of the non-resident fund.

3.5 Taxation of Carried Interest

Since carried interest typically involves the allocation of a share of the underlying profits of the fund to the carried interest participants in a closed-ended fund established as a limited partnership, carried interest participants are subject to tax according to the character of the underlying profits allocated to them (dividends, interest, capital gains, etc). There is also a minimum capital gains tax rate of 28% on carried interest, which applies to all carried interest regardless of the character of the underlying profits that comprise the carried interest.

Income-Based Carried Interest

There are also special rules called the "income-based carried interest" (IBCI) rules, which may mean that carried interest is taxed as trading income at marginal income tax rates of up to 45% (plus national insurance contributions).

The rules on IBCI are complex, but broadly require that, on each occasion a UK resident individual investment manager becomes beneficially entitled to receive an amount of carried interest, a determination is made of the average holding period (weighted by the relative values of the assets concerned) of all of the assets ever held by the fund since inception (including assets that the fund may have previously realised). Where this average holding period is 40 months or more, the whole of the carried interest arising on that occasion is treated as capital gains carried interest and is subject to the capital gains tax carried interest tax rate of 28%. Where the average holding period is less than 36 months, the whole of the carried interest is treated as IBCI and is taxed as trading income at income tax rates of up to 45% (plus national insurance contributions). An average holding period of between 36 and 40 months requires a tapering calculation, where a proportion of the carried interest is treated and taxed as IBCI and a proportion as capital gains carried interest, depending on the precise length of the average holding period.

However, where an individual's right to receive carried interest is acquired by reason of employment and is an "employment-related security" for tax purposes, the carried interest will generally not be IBCI (although there is targeted anti-avoidance legislation designed to disregard arrangements that are put in place to circumvent the application of the IBCI rules). The application of the employment-related securities rules themselves, however, may mean that all or a proportion of carried interest is subject to income tax and national insurance contributions as employment compensation of the individual manager.

3.6 Outsourcing of Investment Functions/Business Operations

UK managers are permitted to appoint sub-advisers, to delegate their investment management functions, or to outsource other material functions (eg, compliance monitoring) to third parties, subject to compliance with related rules from the AIFMD and MiFID II. These rules include obligations to conduct due diligence on the providers of outsourced or delegated services, to specify the terms that must be included in the agreements for such services and to require ongoing supervision of the performance of the delegated or outsourced function. Additional obligations apply in the delegation of investment management functions by UK AIFMs, such as the obligation to ensure that the UK AIFM retains sufficient investment management functions so as not to become a "letter-box entity", and obligations to notify the FCA of the intended delegation.

3.7 Local Substance Requirements

As a condition to authorisation, a UK manager must maintain UK premises and sufficient qualified staff to carry out key functions (including senior management requirements, compliance functions, investment professionals and, in the case of managers authorised as AIFMs, non-investment professionals who carry out valuation and risk management functions). UK managers are also required to maintain sufficient financial resources on an ongoing basis to meet the applicable regulatory capital requirements (which are generally based on a portion of their fixed annual expenditure as well as, in the case of managers authorised as AIFMs, their assets under management).

3.8 Local Regulatory Requirements for Non-local Managers

Managers that do not have a place of business in the UK and are not required to be authorised by the FCA are not subject to any additional requirements. As detailed in **4.2 Marketing of Alternative Funds**, financial promotion restrictions and national private placement regimes will apply to all managers marketing their funds in the UK.

4. Investors

4.1 Types of Investors in Alternative Funds

There is significant interest in alternative funds from investors in the UK. Significantly, more AIFs (EU and non-EU) have been notified for marketing in the UK than in any other EEA jurisdiction. UK institutional investors are significant participants in all types of alternative funds, and the UK ultra-high net worth individual market is particularly active. In addition, some of the largest asset allocators and advisers to participants all over the world are based in the UK.

4.2 Marketing of Alternative Funds

Offers of funds to investors in the UK are subject to the restrictions of the UK financial promotion regime, as well as the conditions for marketing established under the UCITS Directive and the AIFMD, as relevant to the fund structure. UCITS and NURS can be offered to all types of investors in the UK.

QIS and unregulated funds (established in the UK or elsewhere in the world) may be offered to "professional investors" (as defined in MiFID). These types of investors include regulated financial institutions, pension plans, central governmental entities or large corporate investors ("per se professional clients"). Offers of such funds may also be made to so-called "elective professionals", which may include high net worth individuals who have requested to be treated as professionals and who meet two of the following three tests:

- the investor has invested in similar investment products (eg, AIFs) in significant size at an average frequency of ten per calendar quarter;
- the size of the investor's investment portfolio exceeds EUR500,000; and
- the investor works or has worked in the financial sector for at least one year as an investment professional (provided such position involves having knowledge of investing in similar products).

Local government authorities and their pension schemes are not considered to be per se professionals, but may be categorised as "elective professionals" using a separate test set out in the FCA rules. Investors that are not "per se" or "elective" professionals (including high net worth individuals that do not meet the elective professional test) are categorised as retail investors.

If marketing is undertaken by an FCA-authorised firm (eg, the manager or third-party distributor), an unregulated fund or QIS may also be offered to certified high net worth individuals, sophisticated investors and certain other categories of investor set out in the FCA rules.

Unregulated private equity funds that invest in unlisted equity or debt may be offered to certified high net worth individuals and sophisticated investors by both FCA-authorised persons and managers or distributors established outside the UK, subject to compliance with pre-qualification (and certification in prescribed form) and additional investor disclosure requirements.

4.3 Rules Concerning Marketing of Alternative Funds

Following Brexit and the end of the EU withdrawal period, UCITS funds established in EEA member states no longer have the benefit of the UCITS marketing passport, subject to the transitional arrangements for existing EU funds.

AIFs established outside the UK must be notified for marketing to the FCA under the UK private placement regime. The conditions for the private placement regime (in addition to prior marketing notification) include compliance with investor disclosure and reporting, and regulatory reporting obligations set out in the AIFMD. Furthermore, funds and managers that are established outside the UK must be established in a jurisdiction that has entered into a co-operation agreement with the FCA.

A separate "lighter touch" private placement regime exists for alternative investment funds managed by "sub-threshold" AIFMs (see **3.2 Managers: Regulatory Regime**).

Offers made at the initiative of a UK professional investor (ie, in response to a reverse solicitation) do not require notification to the FCA or compliance with the AIFMD investor disclosure or reporting obligations, but remain subject to the restrictions of the UK financial promotion regime (see **4.2 Marketing of Alternative Funds**).

4.4 Local Investors

Subject to the rules on marketing, there is no restriction on UK investors investing in funds established in the UK.

4.5 Investors: Regulatory Regime

See **4.2 Marketing of Alternative Funds** with regards to the marketing of UCITS.

AIFs established outside the UK must be notified for marketing. Pre-investment disclosure and periodic reporting obligations apply. Regulatory reporting obligations ("Annex IV reporting") also apply, with regards to assets under management, exposures, leverage, markets and key counterparties.

AIFMs that notify their AIFs for marketing are required to comply with rules in respect of acquisitions of controlling stakes in UK companies (listed and unlisted) as a condition for offering their funds in the UK. These include the requirements to make certain notifications and disclosures to the board of the portfolio companies, other stakeholders and the regulator. In addition, they are not able to facilitate, support or vote in favour of distributions, capital reductions, share redemptions and acquisitions of own shares by portfolio companies within the first 24 months following the acquisition ("asset stripping rules").

4.6 Disclosure Requirements

Both the FCA's COLL (applying to UCITS, LTAF, NURS and QIS) and FUND (applying to AIFs) Sourcebooks set out detailed investor disclosure obligations that apply if the fund is established in the UK or notified for marketing under the UK private placement regime (see **4.3 Rules Con-**

cerning Marketing of Alternative Funds). See also **2.17 Disclosure/Reporting Requirements**.

4.7 Investors: Tax Regime

Partnership Funds

UK investors in partnership funds are subject to tax on their allocations of the underlying income and gains of the partnership (whether or not distributed to them), as these funds are tax-transparent for UK tax purposes. UK investors are treated as receiving a share of all of the underlying income and gains that make up their allocations of partnership profits (dividends, interest, capital gains, etc) and are subject to tax according to their particular UK tax status. As noted, where any such income or gains have suffered tax in another jurisdiction (eg, by way of a withholding tax), UK investors may be able to take advantage of the terms of an applicable double-tax treaty between the UK and the other jurisdiction to reduce or eliminate such non-UK tax liability. UK investors may also be entitled to reduce their UK tax liability on such income or gains by claiming a foreign tax credit for the non-UK tax paid on such items of income or gain.

UK-Authorised Funds

UK tax resident investors in UK-authorised funds such as AUTs/OEICs and approved investment trusts (but not PAIFs or UK REITs) are treated for UK tax purposes in the same way as they are where they hold shares in a regular UK company. Accordingly, UK tax resident individuals will be subject to income tax (at rates of up to 39.35%) on dividends they receive from such funds, but UK corporation tax payers may be entitled to an exemption from UK taxation of dividend receipts from such funds, subject to the particular circumstances.

Bond Funds

Where a UK-authorised fund is a "bond fund" (see **2.11 Funds: Tax Regime**), interest distributions paid by these funds are treated as interest receipts (and not as equity dividends). Accordingly, UK tax resident individuals receiving an interest distribution will be subject to income tax at rates of up to 45%, and such distributions will form part of the taxable loan relationships income of corporation tax payers.

PAIF/UK REIT

Where the fund is a PAIF or a UK REIT, distributions are treated in the same way (dividend distributions as equity dividends and interest distributions as interest receipts), unless the distribution is a property income distribution (a PID), in which case the distribution is treated as if it were income from a UK property rental business. PIDs are, therefore, taxable property income for a corporation tax payer and, as income, are chargeable to income tax (at rates of up to 45%) for a UK tax resident individual (with a tax credit for any income tax withheld on payment of the PID).

Non-UK Funds

Where a UK tax-resident investor invests in a non-UK fund (other than a partnership), distributions from the fund to the investor are taxed in the same way as any other dividends received from a non-UK company. Additionally, under the UK's "offshore funds" regime, capital gains realised by UK tax resident investors when they redeem their interests in offshore funds are taxed as if those gains were income (so at rates of up to 45% for a UK tax resident individual investor), unless those interests have been interests in a "reporting fund" since the investor has held them. Entry into the "reporting fund" regime is by election by the fund to HMRC. However, it is a condition of the "reporting fund" regime that the fund calculates its "reportable income" for each period of account ("reportable income" being the income of the fund net of expenses other than performance fees, but not including the fund's capital gains) and notifies each relevant investor of its share of "reportable income" for that period of account.

To the extent that the fund has not already made a distribution to investors, a UK investor in a "reporting fund" must treat itself as having received a deemed distribution of its share of the fund's reportable income six months after the end of the relevant period of account, on which the investor is subject to regular UK dividend taxation (at the rate of 39.35% for an additional rate tax payer). The amount of any distribution of this kind is also added to the investor's capital gains base cost for its shares and so reduces the amount of any capital gain realised by the investor on the ultimate redemption of its interest.

4.8 Foreign Account Tax Compliance Act (FATCA)/Common Reporting Standard (CRS) Compliance Regime

UK funds are Foreign Financial Institutions under FATCA and Financial Institutions for the purposes of CRS. The UK and USA have entered into a Model 1 intergovernmental agreement to implement FATCA in the UK, so that UK funds will be required to register with the IRS and obtain a Global Intermediary Identification Number (GIIN), but will not be subject to FATCA withholding taxes. UK funds are, therefore, required to obtain certain specified information from their investors (including the name, residential address and tax identification number of the investor) and to report that information, together with information about the amount of income or gain credited to the account of the investor, to HMRC annually under the FATCA and CRS reporting regimes.

Schulte Roth & Zabel (SRZ) is widely regarded as the preeminent firm for hedge, private equity, credit and regulated funds. With more than 80 lawyers focused exclusively on representing investment funds and their managers, we expertly guide our clients through the creation and structuring of investment funds across every conceivable strategy. We focus as much on setting up the managing entity as we do on the fund itself, assuring its successful operation over the long term, and our vast knowledge about regulatory and compliance issues means that we provide our clients with the most incisive advice as they operate the fund.

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