

THE  
INVESTMENT  
ASSOCIATION

# IA UK FUNDS REGIME WORKING GROUP

# Final report to HM Treasury Asset Management Taskforce

6 June 2019



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## FOREWORD FROM THE IA CEO



The UK is one of the most vibrant asset management centres in the world, serving many millions of domestic and international customers. This benefits people and businesses across the country, supporting 100,000 jobs in the sector and contributing £4.5bn in tax every year.

As part of Investment Management Strategy II (IMS II), Government, industry and regulators have been considering how to strengthen our competitive position further. A key aim is to ensure that the UK industry can continue to provide a world class product set to its customers, while also contributing sustainably to economic growth.

At the heart of IMS II is the Asset Management Taskforce, chaired by the City Minister, which has been considering a wide range of highly relevant issues for the industry and society, including diversity, skills, sustainability, stewardship and technological change. Getting these 'big picture' issues right will be critical to the long-term success of the industry.

In particular, the Taskforce has focused on the shape of the UK fund regime, a critical piece of the jigsaw of ensuring that the UK's investment industry can continue to flourish in a rapidly changing world. Last year, the Asset Management Taskforce asked the Investment Association to establish a group to look at how to ensure that the UK fund regulatory and tax regime can develop and grow in the context of changing customer needs, changing capital markets and, of course, Brexit.

Under the excellent chairmanship of Maarten Slendebroek and with expert input from across the industry, the UK Funds Regime Working Group has prepared its final report. Its conclusions are important and contain significant proposals to ensure the UK industry can deliver in a rapidly changing landscape.

I would highlight in particular the importance of the Long-Term Asset Fund (LTAF) proposal in broadening access to private assets including Patient Capital. It is a reminder of our core purpose as an industry of investing effectively for customers over the long term, adapting to changing needs and helping to drive growth and innovation in the wider economy.

Since the Report was drafted and submitted to HM Treasury in June, the debate has clearly moved further with a renewed focus on the role of illiquid assets in fund portfolios and on industry standards of governance and transparency. Our paper, 2025 Vision, sets out a wide-ranging set of actions for industry, in partnership with regulators and policymakers, to ensure that we can deliver successfully over the coming years. The LTAF is a key part of that vision, not a specific response to recent events.

I would like to take this opportunity to thank Maarten and all those who have contributed to this significant report. At a time of renewed focus on the UK's future relationship with Europe and the rest of the world, we look forward to working further with Government and regulators in driving forward this dynamic domestic and international delivery agenda.

Chris Cummings

31 July 2019

## CHAIRMAN'S FOREWORD



The UK fund regime has significant strengths, reflecting the quality of UK regulation historically and the robustness of the UCITS framework at EU level. Strong customer protection sits at the heart of the UK regulatory approach and this should always be an important foundation for the retail savings market.

Over the last 10 years, the pace of change in the environment in which we operate has accelerated. The UK funds industry has grown significantly, both in terms of funds under management and the breadth of strategies available in the domestic market. The retirement income market has been revolutionised. The demand for a wider approach to investment beyond public markets has increased significantly, as well as the demand for ever more sophisticated approaches to meeting customer needs, particularly in the institutional market. The time is therefore right to look afresh at the UK's fund regime to ensure that it can meet the changes ahead.

Our work over the last year has considered how to ensure that the UK fund regime can adapt, while remaining compatible with UCITS. Our theme is evolution, rather than revolution, and the new structures we recommend – the Long-Term Asset Fund and Onshore Professional Fund – sit clearly within the existing family of available funds. What they do signal, however, is the need to respond explicitly to changing customer needs if the UK is to retain and enhance its fund management capabilities.

Two other themes are important to stress alongside. First, to ensure a thriving domestic savings and pensions market requires much more than simply the right fund vehicles, and action that is beyond our immediate remit. Our Working Group on the Retirement Market highlights a number of areas that need greater focus, including access to advice and the coherence of what is currently a complex disclosure regime. We also recognise that wider work underway to increase the transparency of charges and costs, objectives and performance reporting is an important ingredient of longer term success.

Second, in the international context, the Group was clear that any changes in regulatory and tax structure will only have an impact if there is an enduring framework for promotion and support from Government and regulators. In that regard, the industry has welcomed initiatives such as IMS II and the FCA's work on the Firm Authorisation Hub.

Brexit brings new opportunities, as well as challenges, for the UK funds industry and the necessary toolkit for UK funds, and the environment in which the industry operates, will doubtless change in ways we cannot yet anticipate. In the meantime, we hope that this Report will provide a strong vision for the future direction of the UK funds industry.

Finally, I would like to thank all the members of the UKFRWG, and in particular the chairs of the three thematic working groups, Alex Cunningham, Julie Patterson and Richard Parkin, as well as Lora Froud, who worked with us on the Long-Term Asset Fund proposal.

**Maarten Slendebroek, Chair of the UK Funds Regime Working Group**

## GROUP MEMBERSHIP / ACKNOWLEDGEMENTS



The Investment Association is grateful to representatives from the following firms that have participated in the UKFRWG and its three sub-groups:

AIMA

Artemis

AXA Investment Managers UK

Better Retirement

BlackRock

BNY Mellon Asset Servicing

Dechert LLP

Depository and Trustee Association

Fidelity Investments International

Hargreaves Lansdown

HSBC Global Asset Management

Jupiter Asset Management

KPMG LLP

Legal & General Investment Management

Link Asset Services

M&G Investments Limited

Macfarlanes LLP

Man Fund Management UK Limited

Morgan Stanley Investment Management

Newton Investment Management

Northern Trust Global Fund Services Plc

Premier Portfolio Managers

Richard Parkin Consulting

Schroders

SS&C Depository Services Limited

St James's Place Unit Trust Group

State Street Global Advisors UK

In addition the FCA, HM Treasury and the Financial Services Consumer Panel have participated in discussions that have informed some of the UKFRWG's recommendations. The Final Report comprises the industry's view of the UK Funds Regime and its proposed recommendations for change.



## EXECUTIVE SUMMARY



HM Treasury's Asset Management Taskforce was set up in late 2017, with an overarching objective to maintain a thriving UK asset management industry. It has a specific remit to consider, alongside the international competitiveness dimension, how effectively the industry serves domestic savers and what might be done by the industry to improve this.

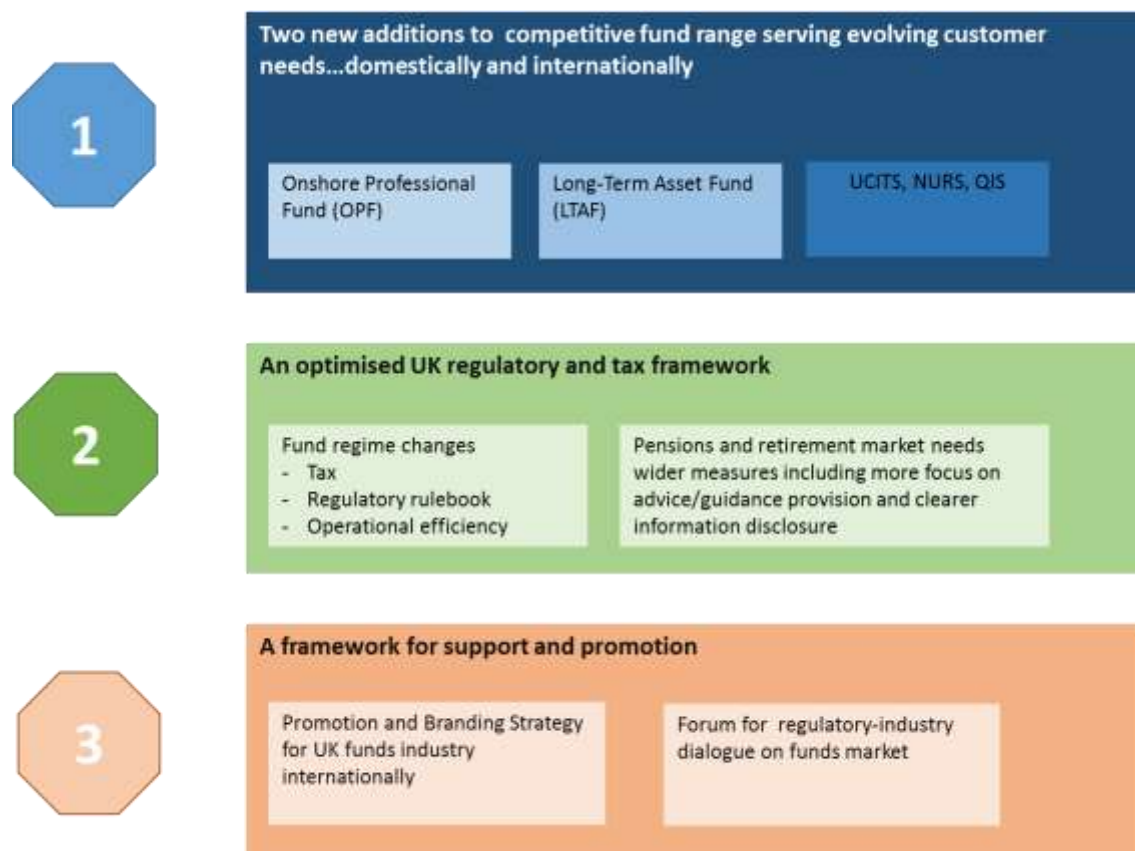
As part of its commitment to help the Taskforce achieve its objectives, the Investment Association (IA) established the UK Funds Regime Working Group (UKFRWG). The UKFRWG has explored how the UK policy, regulatory and tax regime can help to ensure the future competitiveness of the UK fund management sector, from both a domestic and international perspective and has developed a holistic package of proposals designed to achieve this.

This is fundamentally a customer-centric set of proposals, designed to ensure that investors have access to a best-in-class suite of products, within a wider framework for promotion and competitive delivery internationally. This has taken on an added public policy imperative with the advent of automatic enrolment and the pension freedoms, which have expanded the industry's traditional customer base. Auto enrolment has in turn coincided with the global shift into Defined Contribution (DC) pensions, which is further boosting the role of investment managers internationally. In light of these profound changes, the recommendations set out here become more pressing when it means that the retirement income of millions of savers – in the UK and beyond – could be boosted as a result of what is proposed here. UK industry success in delivering in these areas will also contribute to commercial success, reflected in wider economic metrics, including tax contribution.

This Report sets out a blueprint with specific actions in three thematic areas: Innovation, Optimisation and Promotion (see Exhibit 1). Building on strong existing foundations, including recent changes to further drive transparency and competition, the Report's recommendations will help to strengthen the UK's leading place as a global asset management centre. Three additional thematic reports provide much more detail on the Long-Term Asset Fund and Onshore Professional Fund proposals and on the retirement income market. We also provide further analysis in the Annexes of our proposals on tax optimisation and operational efficiency.



## EXHIBIT 1: Delivering for Customers and the Wider Economy with a Globally Competitive Fund Range



## 1. Facilitating Innovation



The industry has innovated in a number of ways over the last decade, with a much wider range of both indexing and active fund strategies now available. While innovation can often take place without the need for specific policy, regulatory or tax changes, some areas require greater facilitation. Reflecting current and anticipated future needs of customers in the UK and internationally, the UKFRWG puts forward specific proposals for two new fund structures that will help to ensure the industry can deliver effectively:

**1. Accessing private markets effectively.** Responding to increasing interest from customers in ways to access investments such as property, infrastructure and private equity/debt through pooled funds, the Report outlines the need – and key features – required for a UK **Long-Term Asset Fund (LTAF)**.

A key priority in developing these proposals has been to ensure that domestic customer groups, including DC pension scheme decision-makers, can invest more effectively. This requires a retail vehicle, and the recommendations are therefore based on the existing authorised Non-UCITS Retail Schemes (NURS) structure, with wide investment flexibility and liquidity requirements that match the underlying assets. The proposal aims to build on current high standards of disclosure, customer protection and operational integrity, including a wide range of liquidity management tools. Further debate is needed about how an LTAF could be made available in the traditional retail funds market.

**2. An attractive regime for professional investors.** Unlike a number of other international jurisdictions, the current UK fund regime does not provide a compelling fund structure for investment in alternative assets or investment strategies, especially for non-UK professional investors. The Report puts forward recommendations for a new type of alternative UK investment fund that is attractive to professional investors, entitled the **Onshore Professional Fund**. This would be distinct from the Qualified Investor Scheme (QIS) and require both an unauthorised corporate vehicle and a substantially enhanced partnership structure.

Looking further ahead, our detailed work on the retirement income market (discussed in Part Two) suggests that there **is scope to facilitate further innovation in the drawdown market with changes to the way in which income and capital are treated within funds**, thereby allowing a more targeted approach to the delivery of sustainable income throughout retirement.

## EXHIBIT 2: A regime for domestic and international customers across the professional/retail spectrum



\*Proposed New Fund Structure/Regime

## 2. Optimising the Existing Regime



The UK fund regime is likely to change after Brexit. Unless otherwise provided for in a new arrangement with the EU, UK-domiciled Undertakings in Collective Investments in Transferable Securities (UCITS) will become third country Alternative Investment Funds (AIFs). UCITS is still the gold standard in fund regulation, particularly in the area of investor protection and this Report does not envisage a significant departure from this foundation. Rather, it identifies a number of areas where enhancements can be made, many of which relate to competitiveness and efficiency issues which would still be relevant in the event that the UK had not decided to leave the EU.

### TAX

The UK tax environment for UK domiciled funds has been reformed over the past few years. This Report **addresses residual areas of tax drag in UK authorised funds** and recommends:

- A full review of the fund tax regime via an industry consultation to remove existing inconsistencies and enhance the attractiveness of the UK as a fund domicile.
- Measures with respect to withholding taxes and access to tax treaties, which become more important to address post-Brexit if UK funds can no longer access the preferential withholding tax rates they are currently able to benefit from due to their EU fund status.
- Changes to the UK VAT regime, highlighting areas that are important for maintaining a competitive UK VAT regime for existing UK funds as well as any new types of UK funds that the government may consider, such as LTAFs or onshore alternative fund structures proposed in Part One of this Report.

### REGULATORY ARCHITECTURE

Authorised funds are regulated by the FCA and must adhere to the regulatory requirements set out in various different parts of the FCA Handbook. Having a **consolidated regulatory framework** will ultimately add to the competitiveness of the UK. To achieve this, we recommend the creation of a single rulebook for funds.

This Report also recommends repackaging NURS fund structures and its subsets as a 'UCITS plus regime' for both domestic and international markets and explores the benefits of promoting master feeder structures as a gateway to open up funds in other jurisdictions.

### OPERATIONAL EFFICIENCY

To address operational efficiency, the industry is already working on a range of projects which will result in material efficiency gains, notably on fund switching and fund settlement. This Report also makes recommendations for an **optional alternative investor dealing model to the traditional model** operating in the UK today. This 'Direct2Fund' model would facilitate investors transacting directly with the funds and remove the Authorised Fund Manager (AFM) as a counterparty to the investor deal.

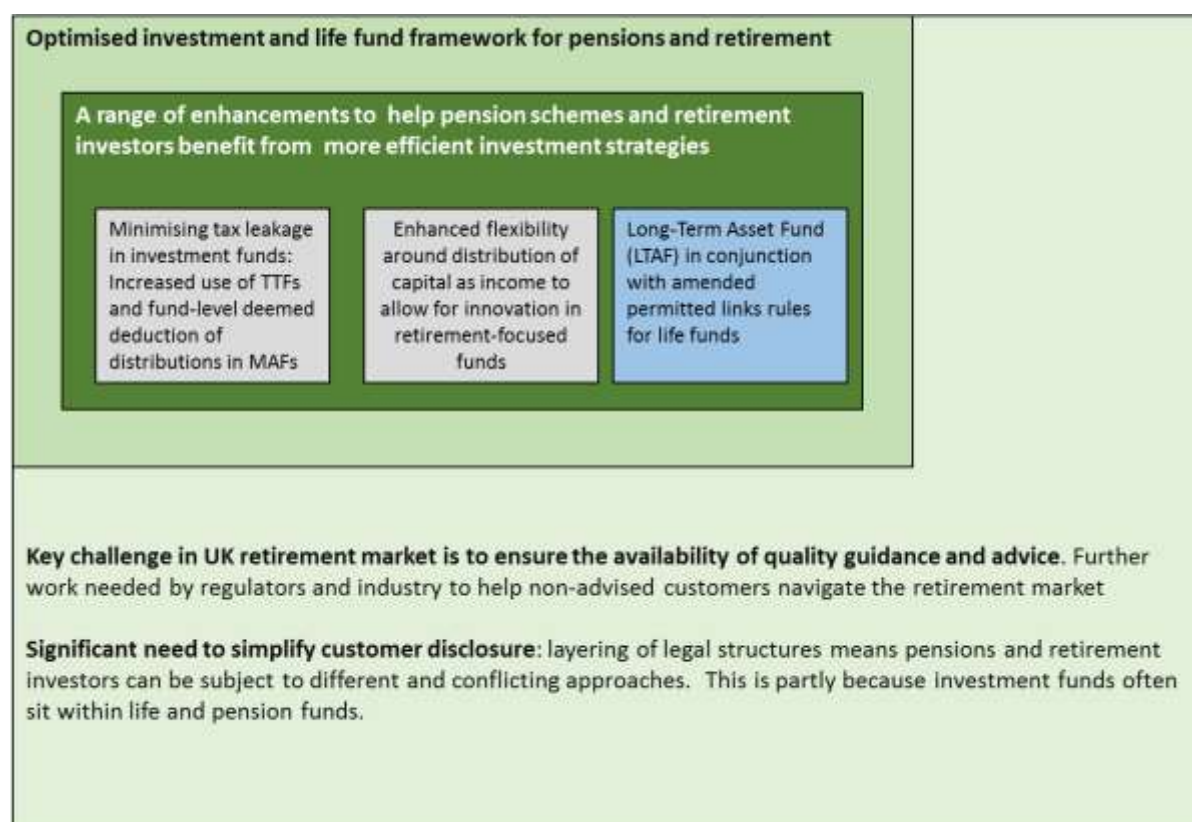
## PENSIONS AND RETIREMENT MARKET

The advent of automatic enrolment and pension freedoms has significantly changed the size and shape of the **UK pensions and retirement markets**, with a shift of investment and longevity risk to individuals through DC pensions and wider coverage to include a group of less financially experienced customers. Alongside increased regulatory scrutiny, it has also prompted the pensions and investment industries to re-consider whether available products best meet the needs of this new breed of customer.

In light of these major changes in the pensions and retirement markets, the UKFRWG has explored whether there are features of the regulatory and tax environment that are an obstacle to an effective role for investment funds in the **retirement fund market**, both in the accumulation and retirement income phases. Overall, our view is that UK authorised funds are already capable of meeting the needs of retirement customers to a significant extent, although we do propose in Part One of this report one specific change to authorised fund rules that we believe could lead to further product innovation in this market

The key conclusion is that more work is needed by government, industry and regulators to ensure the broader market works well. We make a number of recommendations (see Exhibit 3), both fund specific (**designed to minimise tax leakage**) and more general for enhancements through the pensions delivery chain. These focus particularly on **access to advice/guidance and work to ensure greater coherence of disclosure**.

### EXHIBIT 3: Supporting Effective Delivery in the UK Pensions and Retirement Market



### 3. Supporting Competitive Delivery

The regulatory and technical measures set out in Part Two of this Report are a necessary, but not sufficient, condition for success. Two crucial additional elements are also needed and are discussed in Part Three:

- **A commitment to promotion.** Government and regulators should work with the industry to promote the UK specifically as a fund management centre, helping to cement the UK's place as a leading global hub for investment management.
- In an evolving and unusually uncertain longer-term environment, **a framework for on-going dialogue** is needed between asset managers, policymakers and regulators. This could take the form of an 'Investment Fund Forum' which would bring together key participants, including HMT, the Financial Conduct Authority (FCA) and the IA and other industry bodies with an interest in fund regulation.

### Next Steps

As an advisory group within the Asset Management Taskforce, the UK Funds Regime Working Group has set a series of recommendations for further consideration. We provide a summary of key recommendations and associated action points for industry, Government and regulators at the end of this Report.

In terms of delivery framework, this is a package of measures, designed together to facilitate a more effective market. Given the number of separate proposals, many subject to regulatory development, the timetable will depend in part on regulatory capacity, which we recognise is constrained in the context of Brexit preparation. The industry would like to aim for implementation of the package within 18 months (i.e. by end 2020).

# INTRODUCTION



## BACKGROUND

With the UK asset management industry managing over £8.1trn for individuals and institutions, the UK remains a primary centre of asset management globally and the pre-eminent centre in Europe. As a fund domicile, it has been less successful, notably relative to Luxembourg and Ireland, and the UK is ranked fifth in the European Union (EU) in terms of funds under management.<sup>1</sup>

The scale of this can partly be illustrated by comparing the size of industry infrastructure relative to the domestic economy. Assets under management in the UK are equivalent to almost 400% of GDP, compared to just over 50% for funds. The Irish funds industry is equivalent to some 624% of GDP. For Luxembourg, the scale is of an entirely different order (6,038%).<sup>2</sup> Helping the UK become a leading fund domicile jurisdiction ultimately adds to UK economic growth, both in terms of job creation and greater tax revenues.

From a global perspective, total funds under management were estimated to have reached \$50trn by the end of 2018, with Europe accounting for some 30% of this.<sup>3</sup> Given changing demographics, increasing global wealth and a structural shift in responsibility towards individuals for saving in many jurisdictions, the importance of the global funds industry is likely to increase further. While much of this will remain domestic, there is an opportunity for the UK to think more ambitiously in terms of how it positions itself in the global market.

The historic reasons for the greater success of other European jurisdictions as fund domiciles have been well explored. There is no single determining factor, but a combination of elements, notably the tax and regulatory environment, as well as the active sponsorship and promotion by their respective governments, facilitated the emergence of Luxembourg and Ireland as leading fund domiciles through the late 1990s and early 2000s.

Over more than a decade, extensive work has been undertaken by industry, Government and UK regulators to address some of the issues identified as contributing to this relative lack of competitiveness in the area of fund domicile.

The competitiveness agenda was given significant formal impetus by the Government's Investment Management Strategy (IMS) programme. IMS I, published in 2013, aimed at enhancing the UK's market share among fund domiciles. Notable achievements arising from IMS I included the abolition of Schedule 19 Stamp Duty Reserve Tax for UK authorised funds, and the removal of stamp duty on the purchase of shares on the London Stock Exchange of Exchange Traded Funds (ETFs) established and authorised in the UK, both of which were perceived as obstacles to the competitiveness of the UK as a fund domicile. This was then followed in December 2017 by IMS II, which has aimed to create an environment in which firms can deliver the best possible outcomes for investors, businesses and the UK economy.<sup>4</sup> To facilitate this, the Strategy focuses on six areas for growth, one of which is

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<sup>1</sup> IA Annual Survey, Asset Management in the UK 2017-18, p.82.

<sup>2</sup> IA Annual Survey and IA calculations

<sup>3</sup> EFAMA International Statistical Release Q4 2018

<sup>4</sup> HM Treasury, 'The UK Investment Management Strategy II', December 2017, pg. 3



enhancing government, regulatory, and industry dialogue through the HMT Asset Management Taskforce.



## PURPOSE OF GROUP AND REPORT

Through the HMT Asset Management Taskforce, the Investment Association (IA) committed to look at how to help the UK retain and build on its global competitive position and pro-actively facilitate the existence of a world-class, customer-focused and technology-enabled fund management centre. As part of the process, the IA set up the UKFRWG, comprised of senior figures from the asset management industry, as well as Government, the FCA and the Financial Services Consumer Panel.

This Report is the output from the UKFRWG and puts forward concrete recommendations that, as a whole, create a single vision for ensuring UK competitiveness going forward, rather than exploring particular measures in isolation.

It is important to emphasise the solid foundation upon which our proposals build - the UK already has a world class infrastructure, including a best in class FinTech sector, that supports the wider asset management industry, on which the funds industry can leverage, with a fiscal and regulatory regime that has been subject to a range of positive initiatives in recent years.

The UK depositary industry is similarly well-developed and well-regarded. The UK governance structure for authorised funds is built around the segregation of duties between the Manager and the Depositary. This segregation of duties is the most fundamental element of investor protection provided by authorised funds. The UK also has access to global custodian networks, allowing investment by funds in almost any jurisdiction in the world.

There are, therefore, no 'silver bullets' that will significantly improve UK competitiveness. Rather, the Report identifies a range of actions across multiple themes including regulation, tax and operational efficiency that together could significantly enhance the UK fund sector both from a domestic perspective and as an international fund domicile.

## WIDER CONTEXT

The Report is written in the context of significant domestic changes affecting the way in which the asset management industry serves its customers in the UK. These can be categorised into the following areas:

- *Evolving customer needs / new market opportunity.* This is seen most clearly in the context of the changing pensions landscape, including the retirement income market. A combination of automatic enrolment and the Government's Pension Freedom and Choice reforms mean that the asset management industry is more directly connected to customer outcomes than at any time in its recent history.
- *Evolving economic needs and societal expectations.* There is a shift both domestically and internationally towards greater use of market-based finance that is seeing an intensifying focus on less liquid investment, including public infrastructure. That shift is also coinciding in the EU, in particular, with a strong focus on responsible and



sustainable investment amid accelerating activity to address both climate-related threats and broader priorities in areas such as social impact projects.



- *A greater focus on disclosure and customer value.* A combination of significant regulatory intervention, stakeholder and industry initiatives are contributing to a step change in governance and disclosure standards.

This Report's proposals are complementary to those initiatives, seeing high levels of competition, transparency and consumer protection in the domestic landscape as a key foundation for the international competitiveness issues discussed within the UKRFGW. Alongside actions identified in this Report for Government and regulator, the industry recognises its responsibility to ensure effective delivery across the retail and institutional markets.

## GUIDING PILLARS FOR MOVING FORWARD

HMT has articulated a set of three pillars as part of its international competitiveness strategy for financial services<sup>5</sup>. We present our proposals in the context of these three pillars, which are mutually reinforcing and closely interconnected:

- **Innovation** will ensure that the fund industry is able to serve customers most effectively, both in the UK and overseas. *Innovation requires a diverse, energised, responsive industry. It also requires a supportive, facilitating and adaptable wider environment.* This report outlines a range of areas where industry, Government and regulator have a specific role to play in innovation, including specific proposals for change both in the operating model and regulatory treatment of investment funds.
- **Resilience** has many dimensions, but in the context of the UK fund environment, we particularly emphasise our support for a regulatory and fiscal environment that fosters a financial services eco-system that can adapt both to Brexit and to other transformational challenges ahead, whether in terms of technological change or the evolution of the international trading environment. The report contains a number of proposals designed to deliver better outcomes in this area, including a more attractive onshore professional investor regime.
- **Openness** involves a combination of elements that together will help to make the UK a 'go to' destination as a domicile, including attractiveness to diverse talent, access to overseas markets, strong international regulatory engagement and trade promotion. These elements are also relevant and important for the wider asset management industry. Another aspect here is openness of dialogue between government, industry and regulator which is a pre-requisite for long-term success, as the Investment Management Strategy II document suggests.

Underpinning these pillars, the Report strongly underlines the importance of promotion to ensure the long-term success of the UK as both a fund and asset management centre.

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<sup>5</sup> Mansion House (June) 2018: Speech by the Chancellor of the Exchequer

# 1. OPPORTUNITIES FOR INNOVATION



- 1.1 Innovation is a multi-faceted process, affecting the nature of products being offered to customers, distribution processes and underlying operational infrastructure. Getting this right is a responsibility for all stakeholders, first and foremost the industry itself. Regulators and Government have a critical role to play alongside in helping to shape the constraints – and accelerators – that will influence how the UK industry delivers domestically and internationally.
- 1.2 From a product perspective, there are a range of recent examples of innovation in the funds industry:
- The introduction of Exchange Traded Funds (ETFs) has added a significant new access point for those wishing to track an index, and ETFs are available for some active managed strategies.
  - A new generation of funds has emerged that are much more specifically targeted at outcomes, for example, control of volatility. In the current context of the low yield environment and the Pension Freedoms, there is also wider availability of funds with income objectives, notably multi-asset income.
  - Liability Driven Investment (LDI) funds are making strategies originally developed on a bespoke basis for large DB pension schemes available in a pooled form to a wider range of DB pension schemes that might not previously have had the scale to access these strategies on their own.
  - The first Social Impact funds are aiming to achieve both a good investment return and positive social outcomes.
- 1.3 Looking ahead, the industry is looking carefully at how sustainable and responsible investment approaches can develop further. This has implications for fund products as well as the underlying investment process, whether for pooled or segregated services.
- 1.4 The industry is also putting in place mechanisms to communicate more effectively with customers, drawing on customer insight work and a range of regulatory findings calling for greater clarity of delivery objective as well as associated charges and costs.<sup>6</sup> As digital delivery accelerates further, and behavioural insights are better applied by both industry and regulators, we would expect significant changes in the way in which communication with customers takes place.
- 1.5 At the same time, innovation is accelerating at the operational level. In the context of modernisation of the fund manufacturing and distribution process, standards are being developed to accelerate switching and fund settlement processes. We explore

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<sup>6</sup> See in particular, IA Fund Communication Guidance, 'Clarity of language in fund documentation' produced in collaboration with the Wisdom Council:  
[https://www.theia.org/system/files/legacy/assets/files/press/2019/Fund%2520Communicati%2520Guidance\\_FINAL.pdf](https://www.theia.org/system/files/legacy/assets/files/press/2019/Fund%2520Communicati%2520Guidance_FINAL.pdf)

further areas for specific industry-led change on pg.38 in our proposal on the Direct2Fund model.



- 1.6 This is all taking place in a wider environment of technological transformation which will have implications for all aspects of fund and asset management activity, from investment through to customer communication. The IA is playing a leading role in this area, having established Velocity<sup>7</sup>, a specialist FinTech accelerator and innovation hub. Velocity has over 100 FinTech firms operating in its ecosystem and is embarking on its second cohort of Velocity Innovators selected by an industry panel to build and develop industry adoption of tech. Ultimately, the aim of Velocity is to ensure the industry remains globally competitive to the benefit of savers and investors. In the context of the HM Taskforce and the fund competitiveness agenda, the IA and its member firms will continue to work towards the most fully digitally-enabled fund management environment in the world.

## HOW THE UK FUND REGIME CAN SUPPORT INNOVATION

- 1.7 UK asset management companies operate a wide range of fund delivery vehicles, both UK and overseas domiciled. The key focus of this Report is to ensure that the underlying fund regulation and tax architecture will be able to support future innovation. In terms of specific thematic priorities, the UKFRWG set about exploring three areas identified as highly salient for the competitiveness agenda:
- How to facilitate access to illiquid assets / private markets, helping both to meet the investment needs of customers and the wider funding needs of the economy.
  - How to compete effectively internationally in areas targeted by professional investors.
  - How to ensure that current investment fund products meet the needs of the defined contribution pensions and retirement income market.
- 1.8 Consideration of these areas resulted in significant discussion and stakeholder engagement with IA members, consumer groups and buy side players, including pension schemes and platform providers, to assess viability. The conclusions of the work are set out in the rest of this section.
- 1.9 There are clear inter-connections between Part One and the options for enhancing the regulatory regime discussed in Part Two. In Part Two, we discuss in more detail how the underlying regulatory and tax treatment of funds may evolve, building in particular on the success of the Undertakings for the Collective Investment of Transferable Securities (UCITS) Directive, which has become a globally recognised gold-standard brand in fund regulation, especially in the area of retail investor protection. We also discuss how the pensions and retirement income market can be better supported.
- 1.10 In the specific context of retirement income, we do not have proposals for new fund structures, believing the market to be well served by existing funds and for the gap

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<sup>7</sup> <https://www.iavelocity.com>

on use of illiquid asset classes to be filled by the proposal for a broader Long-Term Asset Fund. However, we note that the current treatment of income and capital within authorised funds may inhibit future innovation in the retirement income market. Specifically, allowing funds to make distributions out of capital in addition to income, may aid the development of funds that aim to target an income stream while drawing down on individuals' capital.

- 1.11 A key example here would be 'bond ladders', under which predictable income over a pre-determined number of years can be achieved by constructing a portfolio of bonds that mature sequentially in every year of the portfolio's existence. Each year's income is provided by annual coupon payments and the return of capital on the bond that matures in that year. Such an approach, which is common in the US retirement market, can be an efficient and flexible way of generating a stable and reliable retirement income while avoiding leaving capital behind for those customers that do not have any bequest motives. While retirement investors can achieve income through the cancellation of units by their platform or product provider, the bond ladder approach offers an alternative option to customers.
- 1.12 Given that demand for such greater flexibility may emerge in future years as the new retirement market develops further, the **UKFRWG recommends that this issue should be subject to review and discussion as part of the ongoing industry-regulatory dialogue that forms a separate recommendation of this Report.**

## LONG-TERM ASSET FUND



- 1.13 At a broad level, the key question is how to serve the changing needs of customers while also ensuring that the broader needs of the economy can be met at a time when both government and companies are looking to sources of market-based finance outside public markets.
- 1.14 In the context of a low yield environment and a desire for broader diversification of investment, there is increasing interest from customers in accessing non-traditional asset classes, such as private markets, through pooled funds. A challenge with this though is that they do not have the same liquidity characteristics as listed investments.
- 1.15 From a supply perspective, we are seeing a wider growth in private markets that is the result of a range of drivers, including shifts in company fund-raising away from public markets and a greater need to secure finance for public or quasi-public infrastructure. Whilst the current low yield environment may not represent long term market expectations, it has meant that investors are seeking a range of different solutions to provide diversification in different market conditions. The investment characteristics of private market assets are such that they are able to provide a degree of diversification from large movements in public equity markets which is a valuable tool when constructing a long term investment portfolio.
- 1.16 The demand shift on the pooled side is particularly seen in the DC market and more generally in the wealth management markets. Government is also keen to promote investment in 'Patient Capital,'<sup>8</sup> amid the growth in interest from companies in raising capital through private as well as public markets.
- 1.17 In order to explore how to facilitate a greater flow of capital to this area, the UKFRWG has identified the features required for a UK investment fund specifically investing in illiquid assets. For the purposes of this Report, illiquid assets/private market investments will include non-listed investments typically with a long investment horizon such as real estate, private equity, infrastructure, venture capital and private credit. We refer to the solution as the Long-Term Asset Fund (LTAF).
- 1.18 A detailed analysis of the proposal can be found in Annex 1.

### WHAT IS THE PROBLEM THAT NEEDS TO BE SOLVED?

- 1.19 Although structures exist for traditional institutional investors to access illiquid investments effectively, the nature of the UK savings and pensions market is rapidly changing and the demand for suitable open-ended fund products is growing<sup>9</sup>. Investment trusts already provide a valuable solution for investors wanting closed

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<sup>8</sup> In its August 2017 consultation 'Financing growth in innovative firms', HM Treasury defined 'Patient Capital' as "long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses".

<sup>9</sup> An open-ended product is where units in the fund can be created and cancelled at defined intervals to meet investor demands to buy and sell units redeemed at any time, as opposed to closed ended where all units of the fund are issued at the outset.

ended structures, but target investor groups, particularly DC pension investors, are seeking investment vehicles that reflect the values and volatility profiles of the underlying investments for the purposes of reducing correlation with other asset classes.



- 1.20 There is a second important requirement. Significant parts of the DC pensions market and wealth management markets tend to invest in funds that are authorised and suitable for retail investors. This is because of the robust governance and customer protection offered in the context of a distribution process that has strong retail market characteristics. Looking ahead, there may also be much stronger demand within the traditional retail market itself for a product that offers investors a very different risk/return profile from more liquid asset classes, although it is acknowledged that such a product may not be suitable for all categories of retail investor.
- 1.21 The challenge is that none of the three categories of open-ended authorised funds (UCITS, Non-UCITS Retail Schemes (NURS) and Qualified Investor Schemes (QIS)) are truly suitable structures for enabling managers to develop products for retail investors to gain access to private market investments. Although a UCITS is available to retail investors, the investment restrictions applicable to a UCITS under the FCA Collective Investment Schemes Sourcebook (COLL) make it unsuitable given that it is primarily restricted to investments in listed investments and other UCITS and NURS, meaning there is little scope to access private market investments.
- 1.22 Whilst a QIS has sufficient investment flexibility to allow it to access private market investments, its unsuitability for retail investors, other than sophisticated investors, means it is also unlikely to be an option for the DC market, despite the FCA's proposed changes to the permitted links rules<sup>10</sup>. Although the QIS structure could be useful for certain types of wealth managers with professional clients, their high net worth clients are typically categorised as retail investors, who will not always be classed as sophisticated investors. Private wealth managers are generally reluctant to recommend or invest in QIS on behalf of these clients, particularly since QIS are classed as Non-mainstream Pooled Investments (NMPIS), which are subject to strict suitability requirements intended to prevent these being sold to retail investors other than those considered to be sophisticated.
- 1.23 The only one of the three categories of authorised funds which offers any potential solution for retail investors is the NURS. The NURS can be used to engineer a portfolio that provides access to private market investments, but this is a complex and costly structuring process. Without this structuring, the current NURS' suitability is limited in a number of ways, notably in relation to the restrictions on investment and borrowing powers, particularly eligible collective investment schemes, securities and other ownership interests (e.g. partnerships, loan participation); valuation

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<sup>10</sup> The permitted links rules are set out in FCA Conduct of Business Sourcebook (COBS) 21 and set out the investment powers of unit linked life funds, which are the dominant form of fund vehicle in the DC market. While unit-linked funds can invest in an underlying QIS, there are limits on the proportion of the unit-linked fund's assets that can be invested so. At the time of writing the FCA has concluded a recent consultation on changes to the permitted links rules to allow greater access to illiquid asset classes. Final rules are expected later in 2019.

requirements and on frequency of redemptions, which do not align with the liquidity of the underlying assets. Requirements on ownership registration also cause difficulties for depositaries of funds investing in illiquid asset classes. More detail on each limitation can be found in Annex 1.



## RECOMMENDATIONS

1.24 **The UKFRWG recommends the creation of the LTAF as a new pooled vehicle for investors to use in accessing illiquid assets.** The key recommendations for the LTAF are currently as follows:

- **Adapt existing authorised NURS structure.** All existing authorised fund structures have limitations as vehicles for investing in long-term and patient capital assets, but the UKFRWG proposes that the existing NURS structure could be modified to accommodate a new sub-set of rules for the LTAF, similar to the Funds of Alternative Investment Fund (FAIF). This sub-set would have its own label, but use the existing structures and rules of the NURS in respect of operational responsibilities and investor protection. The NURS is a retail fund regime, meaning that NURS funds can be distributed to both retail and professional investors (subject to suitability). The existing legal structures of authorised funds could be utilised, depending on the requirements of investor groups, e.g. corporate (Investment Company with Variable Capital), trust (Authorised Unit Trusts), contractual/partnership (Authorised Contractual Schemes (ACS)). This would be more straightforward than starting with an entirely new fund structure.
- **Investment and borrowing powers designed for illiquid investments.** The LTAF should be able to invest in limited partnerships and have wider powers than current NURS structures to invest in unlisted securities, within a framework of spread limits to ensure a prudent spread of risk. The main differentials from the existing NURS rules would be as follows:
  - Allow up to 100% to be invested in unauthorised collective investment schemes (as with the existing NURS FAIF rules).
  - Allow direct investment in limited partnerships.
  - Dis-apply second scheme restriction<sup>11</sup> on collective investment schemes.
  - Allow up to 100% to be held in unlisted securities.
  - Spread and diversification rules that are appropriate to the illiquid nature of the asset classes.
  - Allow a wider range of derivatives to be held for hedging purposes.
  - Ability to originate or participate in loans.
  - Extended borrowing capacity to enable private transactions.
  - Ability to guarantee loans.
  - Initial investment period after launch.
  - Ability to invest in listed transferable securities, authorised funds and liquid assets.

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<sup>11</sup> COLL 5.6.10 R(3) requires a second collective investment scheme to have a restriction on itself investing no more than 15% of the value of its scheme property in units in other collective investment schemes.



These investment and borrowing powers should be underpinned by a requirement for the LTAF to undertake appropriate due diligence and risk management on the assets to which investors are exposed.



- **Dealing frequency aligned to the liquidity of the underlying assets.** Subject to any platform/operational issues being solved, it should be possible to have a product which offers a dealing frequency consistent with the nature of the underlying assets held within the fund (which could include assets which could be sold quickly to meet more frequent redemptions). This suggests a lower dealing frequency than is normally associated with authorised open-ended funds. We do not envisage the LTAF being daily priced. It would be sensible to allow flexibility so that subscription days and redemptions days do not have to match. This would also help address the challenges presented by underlying assets not being priced on a daily basis and the difficulty with fair value pricing.
- **Strong investor protection measures.** If redemptions were going to be more infrequent than is currently possible, for example, every two years, then perhaps that would trigger requirements similar to those in the European Long-Term Investment Funds (ELTIF) regulation such as appropriate investment advice needing to be taken and/or limit on the amount of an individual's assets/pension pot which can be invested in the fund. Any proposals in this regard would need to be practical for both manufacturers and intermediaries.
- **Option to list/provide secondary trading of units.** The option to list could provide investors with an opportunity to at least transfer their investment on the secondary market if they wanted liquidity during a deferred or limited redemption period, rather than having to wait until a redemption day. Alternative facilities to enable secondary exchanges of units between redeeming and purchasing investors, such as matching services, should also be permissible. The approval of such mechanisms should be subject to the manager being able to demonstrate that pricing and transfer can be delivered in a manner that is fair to investors.
- **Liquidity management.** The level of dealing frequency would drive the liquidity management tools which could be used. The manager should ensure that liquidity can be managed effectively and in line with the redemption terms of the LTAF. To assist with this, LTAFs should be able to use notice periods to manage redemptions. Other key liquidity management tools such as deferred redemption and suspension are important to ensure remaining investors are protected if liquidity is not available. Other liquidity management tools could be developed for this purpose, such as side pockets.
- **Model based valuations.** Since market prices are rarely available for long-term assets such as private equity, private debt, real estate, and unregulated collective investment schemes are valued infrequently, the manager of an LTAF will need to use a valuation model, considering a range of economic information relating to both the particular asset concerned and the wider market.
- **Registration of assets.** COLL 6.6.12R and COLL 8.5.4R should be revised for LTAFs and QIS to allow private market investments to be registered in the name





of the AIF or the AIFM acting on behalf of the AIF, subject to appropriate protections to ensure assets cannot be sold without the knowledge or consent of the depositary, as opposed to the current FCA requirement for non-financial instruments to be registered in the name of the depositary.

- **Tax efficiency.** The tax regime for LTAF should be designed such that it does not give rise to additional tax leakage at the fund level. The nature of alternatives investments by an LTAF would involve use of special purpose vehicles and international structures, which almost certainly necessitates measures beyond the existing tax regime for AIFs. In addition, a competitive VAT regime for management of such a fund would be critical for its success as a suitable alternative to other similar non-UK structures. The current VAT treatment of UK AIFs compares poorly to the VAT treatment of offshore alternatives. Hence it will need to be reviewed to ensure that VAT treatment of LTAFs is on an equivalent footing to offshore alternatives. Seeding relief would be required and it will be important that the LTAF can be seeded by one investor.
- **Tax incentives.** The government may wish to consider offering further tax incentives for investors in LTAFs investing in particular projects such as UK patient capital or infrastructure projects for longer periods, similar to those available for investment in VCTs/EIS. The ISA rules should be modified to ensure that LTAFs are qualifying investments for ISAs, even where dealing is less frequent than every two weeks, so these can be utilised in the ISA portfolios of clients of discretionary wealth managers and advisers.

#### WHAT IS THE POTENTIAL TARGET MARKET?

1.25 From discussions with both asset managers and potential investors, the anticipated potential target market covers the following customers:

- **DC market,** particularly DC default arrangements where trustees and insurance providers wish to make an allocation to long-term investments to provide diversification and the potential for uncorrelated returns. DC schemes typically take two forms:
  - Trust-based schemes can access non-insured funds as professional investors because the scheme trustees are treated as professional clients under FCA rules. However, trustees generally feel more comfortable with selecting retail funds.
  - Insurance-based: any DC scheme accessing investments through a unit-linked insurance contract must look through to the underlying investor, the retail client. In the unit-linked world, the investment must therefore be suitable for retail investors and comply with the permitted links rules in COBS 21.
- **Private Wealth/Discretionary Portfolio Managers,** seeking to diversify into a broader range of asset classes. While the clients of private wealth managers are typically high net worth, they are nonetheless usually still classified as retail investors, and therefore there is a preference in this audience for retail funds.



- **Professional investors**, including institutional investors such as pension schemes, sovereign wealth funds, etc. These have flexibility to choose between a wide range of investment options in long-term investments, including direct, unauthorised funds (including offshore and onshore funds), authorised funds for professional or sophisticated investors such as QIS, QIAIFs (Ireland), or SIFs (Luxembourg), in addition to retail funds.
  - **Multi asset funds/fund of funds** that seek to provide diversified, uncorrelated returns, often within a targeted risk range. The potential for diversification and uncorrelated returns from an allocation to long-term investments is likely to be attractive to managers of authorised funds. While these are generally considered professional investors, fund regulations usually restrict these to investing either predominantly or exclusively in authorised funds.
  - **Local Government Pension Scheme (LGPS) investors** are currently going through a Government-mandated pooling of scheme assets. However, LGPS investors have thus far been unable to find a way to pool illiquid assets in current authorised fund structures and so would benefit from access to the LTAF, which would offer a way to pool illiquid assets in a manner consistent with the Government's requirements for the LGPS.
- 1.26 To be able to access all these target investor groups, the LTAF should be capable of being promoted to retail clients, even if there are restrictions on distribution in the mass retail market (i.e. advised and/or MiFID II complex/non-complex product categorisation). This is particularly important both for the DC market and, as explained above, this is often a feature required for wealth managers.
- 1.27 The UKFRWG recognises the need for significant customer protection in the context of an LTAF framework that may offer access to complex products. At the same time, it is important to recognise that with appropriate communication and risk management tools, less liquid asset classes can be a valuable part of a retail portfolio.

## ONSHORE PROFESSIONAL FUND



- 1.28 There is a strong case for more flexible professional fund vehicles to enable the UK to compete for global opportunities. The UK is an attractive jurisdiction for international investors, as can be observed by the number of securities listed on UK exchanges. The UK Listing Regime, Takeover rules and financial reporting requirements, and their effective enforcement, are world-renowned. UK financial services regulation is a world-leader, and the FCA is viewed overseas as being an efficient and effective regulator.
- 1.29 Given its many attractions, there is a large untapped appetite from UK, EU and international investors to invest in or through the UK, but the perception of the UK fund regime is that there is no suitable vehicle for meaningful investment in alternative products, and that regulatory and tax barriers make the UK unattractive. UK funds attract strong investment from all types of UK investors, but investment from the global market has traditionally gone offshore.
- 1.30 The UKFRWG has explored the case for the introduction of a new type of alternative UK investment fund that is attractive to professional investors, in the UK and globally. Such a fund would assist in promoting the UK's competitiveness in the alternative funds space and would provide the UK with a growth opportunity. Evidence from successful fund domiciles points to strong investor demand for unauthorised fund structures that facilitate investment in alternative asset classes and investment strategies in a tax-efficient manner.
- 1.31 A detailed analysis of the proposal can be found in Annex 2.

### *WHAT IS THE PROBLEM THAT NEEDS TO BE SOLVED?*

- 1.32 The UK has for many decades offered unauthorised unit trusts for professional investors, but only the exempt version is used to any notable degree and only by UK pension funds and charities. The prolonged absence in the UK of appropriate alternative vehicles enabled other jurisdictions to establish themselves as leading, innovative jurisdictions for fund domicile and administration (see Table 1 overleaf).
- 1.33 The UK Qualified Investor Scheme (QIS) was intended to be an attractive export vehicle, but the initial requirements were too restrictive and deterred both managers and investors. The Authorised Contractual Scheme (ACS) has improved the attractiveness of the QIS but only for certain types of UK investors. Other jurisdictions therefore remain dominant as fund domiciles.

**TABLE 1: Fund Sizes and Number of Fund Managers in Key Jurisdictions**

	<b>Cayman Islands</b>	<b>Ireland</b>	<b>Luxembourg</b>	<b>UK</b>
<b>Fund Size (£m)</b>	10,916*	840,575	1,530,785	1,244,731
<b>Number of fund managers</b>	85	374	268	128

\* Number of mutual funds as at 31 March 2019. Value not available.

- 1.34 Post-Brexit (or post any transition period), the UK will lose the Alternative Investment Fund Managers Directive (AIFMD) managing and marketing passports. For European investors, the marketing passport allows them access to UK Alternative Investment Funds (AIFs), but its loss may not be significant for the UK. Recent research for the European Commission found that the AIFMD has not impacted European investors' appetite for non-EEA funds. They continue to access such funds via national private placement regimes or "reverse solicitation". What the UK lacks is an appropriate fund structure.
- 1.35 The current UK fund regime does not provide an adequate fund structure for investing in alternative assets or investment strategies, especially not for non-UK professional investors. The main features of the principal UK fund structures available to professional investors (unauthorised unit trusts, investment trusts, QIS, ACS) are summarised in Annex 2.
- 1.36 Each of the existing fund structures has its place in the UK professional market, but is of limited attraction. The rules for QIS merit some improvements, but this alone would not produce a sufficiently attractive vehicle for non-UK (and for some UK) investors.

### COMPETITOR FUND DOMICILES

- 1.37 Certain jurisdictions, such as the Cayman Islands, Bermuda and Delaware have, for a long time, offered unregulated fund structures that offer investors the opportunity to access alternative assets and investment strategies with relatively few constraints. These fund structures have traditionally been attractive to institutional and professional investors, due to their wide investment powers, innovative investment strategies and attractive tax features. However, ongoing media scrutiny and public perception has increased the attention on tax havens and consequently such structures are slowly becoming less popular with investors, particularly for EU investors. Recent EU-domiciled fund alternatives to the traditional offshore arrangements have been relatively successful.
- 1.38 The Irish Qualified Investment Fund (QIF) and the Luxembourg Specialised Investment Fund (SIF) were introduced in the mid-2000s, followed by the UK QIS in 2009. Both the QIF and the SIF had some success but the UK QIS was rejected at



the outset by the industry and investors due to the requirement that investors could not own 10% or more of the fund. This condition was significantly modified some time later, but QIS (being open-ended investment companies (OEICs) or authorised unit trusts) did not attract much interest until the introduction of the ACS. Even so, they remain of interest only to UK institutions – mainly pension funds (see Annex 2, paragraph 41).

- 1.39 Implementation of the AIFMD in 2013, which requires the AIF manager (AIFM) to be authorised but not the AIF, caused key European fund domiciles to review their regimes and to introduce unauthorised AIFs for professional investors, most notably the Reserved Alternative Fund ("RAIF") in Luxembourg and the Qualifying Investor Alternative Investment Fund ("QIAIF") in Ireland. The QIAIF was designed with the specific aim of securing the benefits of the Ireland/US double tax treaty.
- 1.40 Appendices 1 and 2 in Annex 2 also provide summary comparisons of QIS and Unauthorised Unit Trusts (UUTs) with regulated and unregulated professional funds in some key fund domiciles.

### RECOMMENDATIONS

- 1.41 With some development, the **ACS QIS** could be a suitable vehicle for an onshore alternatives fund for some UK professional investors and possibly for some non-UK investors. However, a world-class domicile requires more than the ACS QIS.
- 1.42 It is clear from successful fund domiciles in Europe and globally that both alternative unauthorised corporate fund vehicles and unauthorised partnership structures need to be available for investors, especially in alternative asset classes and investment strategies. **The UKFRWG therefore proposes that both such vehicles be created in the UK.**
- 1.43 **The UKFRWG supports the proposals from the Alternative Investment Management Association (AIMA)** which has also been working with HMT and HMRC to develop **an alternative unauthorised corporate fund vehicle** for professional investors. In light of Brexit, AIMA identified the need to review the UK fund regime as both a business opportunity and as a defensive measure.
- 1.44 At the same time, an **attractive, unauthorised partnership regime** is also essential in order for the UK to be a competitive and world class fund domicile. This would require substantial amendments to partnership law (as well as to secondary legislation and tax law) to create a distinction between investment partnerships and ordinary commercial partnerships. Partnerships are a popular fund vehicle outside the UK, e.g. in Luxembourg for venture capital and private equity investment. Scottish partnerships are preferable to English/Welsh vehicles as they involve less legal administration, e.g. English/Welsh partnerships are required to list partners at Companies House. Also, Scottish partnerships are "persons in law", so count as one investor, not many. This is of particular benefit in countries such as the US that limit the number of investors in a fund to secure certain treatment under national regulation.
- 1.45 The **UK tax regime** for any new professional fund vehicles needs to ensure that the fund is tax-neutral. In addition, a competitive VAT regime for management of such

fund vehicles would be critical for their success as a suitable alternative to currently available funds outside the UK. Under the current VAT regime, a UK investment manager managing an offshore fund can benefit from full VAT recovery while no VAT is charged to the fund itself. In contrast, the management of UK funds is either exempt from VAT (if they are qualifying funds), or is subject to VAT (otherwise). Most alternative investment funds are not regarded as qualifying funds and hence suffer VAT on their management charges. Where the fund is exempt from VAT, the input tax recovery of the investment manager is restricted. For a UK onshore alternative fund structure to be commercially viable, the current VAT treatment available on the UK management of offshore funds needs to be extended to management of any such new UK vehicles. This can be done, for example, by applying a zero rate of UK VAT to the management of such funds. Attractiveness for both UK and foreign investors must be considered. For instance, the tax regime for UK resident non-domiciled investors makes it expensive for them to invest in the UK.

- 1.46 A new type (or types) of UK onshore alternative investment fund should not be constrained as regards asset classes or investment strategies, or whether it is open or closed-ended, or listed or unlisted. It should be an unauthorised fund that is available to professional investors/semi-professional (e.g. wealth managers) investors. It would be:
- A registered AIF.
  - Managed by an authorised UK AIFM.
  - Overseen by an authorised UK depositary.
- 1.47 It is important to ensure that there is an appetite in the market to act as depositary for such funds. Reduced choice of options for depositaries of such funds would not be conducive to promoting effective competition and may drive up costs for the funds, and ultimately the investors.
- 1.48 The FCA would need to have sufficient and knowledgeable resource available to regulate the managers of such funds, recognising the difference from other types of fund, authorised or regulated. Staff who have experience in offshore professional funds would be an advantage. The FCA should also ensure that authorisation of the managers of such funds is not overly time-consuming or costly.

## 2. OPTIMISING THE EXISTING REGIME



- 2.1 Since its inception in 1985, as outlined earlier in this Report, the UCITS Directive has become a globally recognised brand and is now seen as a gold-standard in fund regulation, especially in the area of investor protection. The original design and evolution of UCITS has been heavily influenced by the UK over the last four decades, most recently evident in the enhanced depositary independence requirements in UCITS V. Identification of a fund as a UCITS has become an important selling point for UK asset managers marketing their funds to both domestic and international investors, both retail and institutional, and to their distributors. Indeed, the importance of the UCITS brand extends beyond Europe, with a number of countries in Asia and Latin America adopting the UCITS brand for their own domestic markets.
- 2.2 Unless otherwise provided for in a new treaty arrangement with the EU, UK domiciled UCITS post Brexit will become third country AIFs for the purposes of EU legislation. Given the importance of the UCITS brand, the UKFRWG has identified the need for a post-Brexit regime that is the equivalent to UCITS, with the same investor protection and investment powers provisions, and which is branded in a way that these can be easily identified as being the same as UCITS (assuming the UCITS brand can no longer be used by UK funds). Consideration should also be given to ensuring minimal disruption to current investors in UK UCITS ahead of and through the Brexit transitional process.
- 2.3 In theory, this objective should be relatively straightforward to achieve today since the UK has already adopted and implemented the UCITS Directive, which is embedded in UK legislation. As such, the current FCA rulebook reflects the requirements of the UCITS Directive and so a UCITS equivalent regime would effectively be a continuation of the current legislative landscape, with only minimal amendments required to reflect the UK's status as a non-EEA state. A key question will be how **to ensure regulatory alignment with UCITS in future, as well as developing a brand that enables the UK UCITS equivalent to be identified by domestic and international investors as such.** We return to the promotion and branding issues in Part Three of this report.
- 2.4 In terms of the shape of the regime, the starting point will clearly be the UCITS framework and the UKFRWG has identified a number of areas where enhancements can be made. The proposals in this section are incremental and should be seen as part of a package that builds on a solid foundation, both in terms of the delivery framework and the progress made by UK Government over the past ten years in removing existing obstacles to international competitiveness, particularly on the tax side. We focus on three areas in particular:
- Remaining tax inefficiencies.
  - Coherence of regulatory framework.
  - Operational competitiveness.
- 2.5 This part of the Report also recommends repackaging NURS fund structures and its subsets as a 'UCITS plus regime' for both domestic and international markets and

explores the benefits of promoting master feeder structures as a gateway to open up funds in other jurisdictions.



## RESOLVING TAX INEFFICIENCIES

- 2.6 Since the publication of the Investment Management Strategy in 2013, the tax environment for UK domiciled funds has been substantially reformed and includes the following measures:
- Introduction of a new tax transparent vehicle in the form of the Authorised Contractual Scheme (ACS).
  - The abolition of 'Schedule 19' Stamp Duty Reserve Tax (SDRT).
  - Abolishing withholding tax on income distributions by bond funds.
  - Introduction of Stamp Duty Land Tax (SDLT) seeding relief.
  - The abolition of SDRT principal charge on purchases of units of UK ETFs.
- 2.7 All of the above changes have helped in simplifying and streamlining the tax position of UK funds and addressed many key areas of concern.
- 2.8 We identify below areas that continue to be problematic from a tax perspective for UK funds, their investors and the fund managers. An important point in this context is that resolution of the issues that we identify below matters both to domestic investors and the international competitiveness of the UK. (See Annex 5 for further details)

## REVIEW OF UK FUNDS TAX REGIME

### ***Tax efficiency of UK Funds***

- 2.9 Funds are intended to act as a tax efficient conduit for investors, offering investors the benefits of collective investments and risk spreading while preserving, so far as possible, the tax treatment that an investor would have if investing directly in the underlying assets. This concept of tax neutrality ensures that there is no double taxation. Any tax drag at the fund level undermines the tax neutrality principle and makes funds less attractive for investors.
- 2.10 Most UK funds generally do not pay taxes due to application of UK dividend tax exemption on income from equity investments at the fund level or the tax deduction for interest distributions by bond funds. However, balanced or multi-asset funds that do not fall within the definition of a bond fund suffer tax on income from derivatives and on any interest income, without a deduction for distribution of such income, which results in a tax drag at the fund level. This is particularly problematic for low expense or zero expense funds as well as for institutional investors.
- 2.11 The existing Tax Elected Funds (TEF) regime does not provide a solution to this problem particularly for retail and tax exempt investors. At a practical level, the TEF



regime does not succeed as evidenced by the fact that there are hardly any TEFs in the market. Anecdotally the complexities of developing the necessary solution to apply the TEF regime effectively outweigh the potential benefits. As a result existing investors in UK funds suffer a tax drag on certain strategies and certain types of funds, which does not exist on identical strategies of funds based offshore.

- 2.12 The current tax rules therefore create inherent tax inefficiency of such products and put such funds at a competitive disadvantage to funds domiciled offshore which are wholly exempt.
- 2.13 While such tax inefficiency only applies in case of specific types of funds with most equity funds and bond funds not suffering any UK taxes, it fuels the perception that UK funds are not tax efficient unlike the offshore funds based in other popular fund locations. Moreover, for those investors that are heavily reliant on multi-asset funds, the issue is real rather than just perception and can result in significant tax drag on investor portfolios.
- 2.14 This problem would only get accentuated with the introduction of any new types of fund regimes that this Report refers to in Part One, to the extent that such new funds are balanced or mixed asset in nature. In particular we note that in the context of the UK DC accumulation and retirement markets, the use of multi-asset funds is growing strongly and so these investors will be materially disadvantaged under the current tax treatment of these funds.
- 2.15 The current tax regime of UK authorised funds is predicated on the taxation of UK investors taking into account the difference in the tax treatment of dividend and interest income. With the introduction of the tax-free allowance for savings interest and dividends and the abolition of dividend tax credits the tax framework of UK investors has evolved, reducing the need for such differentiation.
- 2.16 There are a number of potential solutions that range in complexity and costs some of which are listed in Annex 5. **The UKFRWG strongly recommends a full industry consultation on the various options.**
- 2.17 While considering the tax regime for any UK fund vehicles, a review of the shape and the coherence of the UK tax treatment of existing, as well as new funds needs to be carried out to enhance the attractiveness of the UK as a location for fund domicile. The review could involve various alternatives such as simplifying the existing special tax regime for UK funds or introducing a new fund tax regime with the option to convert existing funds to the new regime, with the ambition that such a fund would have no tax filing requirements.

### ***The 60% Test***

- 2.18 An additional complication for UK authorised funds is the need for constant monitoring of the qualifying investment test (applying to interest bearing assets) throughout the year under the Authorised Investment Funds (Tax) Regulations 2006 ("the 60% test"). Given the challenges in the monitoring of this test, many balanced funds are treated as equity funds and therefore become less tax efficient for investors for reasons set out above.

- 2.19 **The UKFRWG highlights that possible solutions could include availability of advance clearance procedures or a less frequent monitoring requirement (say every 3 years) of the 60% test with a Genuine Diversity of Ownership (GDO) requirement to limit avoidance.**



#### VALUE ADDED TAX (VAT)

- 2.20 A competitive VAT regime that allows businesses to effectively manage their VAT costs is a vital consideration. VAT can be a significant cost to UK-based fund managers when managing UK funds, disproportionately impacting business decisions.
- 2.21 More consistent and comprehensive application of the current VAT exemption for fund management would be beneficial but, fundamentally, **a competitive UK VAT regime for existing and new funds is critical for their success as a suitable alternative to offshore funds.**
- 2.22 Under the current VAT regime, a UK investment manager managing an offshore fund can benefit from full VAT recovery while no VAT is charged on the fund itself. In contrast, the management of UK funds is either exempt from VAT (if they are qualifying funds), or is subject to VAT (otherwise). Where the fund is exempt from VAT, the input tax recovery of the investment manager is restricted. For a UK fund structure to be commercially viable, the current VAT treatment available on UK management of offshore funds needs to be extended to management of comparable UK vehicles. This can be done for, example, by applying a zero rate of UK VAT to the management of such funds. We note, however, that under current EU VAT law it would not be possible for such zero-rating provisions to be introduced in the UK.
- 2.23 Funds offer investors many advantages through collective investments over direct investments including access to professional investment managers, diversification and risk spreading, economies of scale, ease of access to certain investments, lower transactions costs etc. The management of collective investments entails the outsourcing of certain functions necessary for such funds to operate to specialised service providers. The exemption for fund management services provided to special investment funds [referred to as the 'SIF VAT exemption'] provided under Article 135(1)(g) of the Principal VAT Directive aims to ensure tax neutrality between direct investments (whereby investors do not incur VAT) and indirect or collective investments. A clearly defined interpretation of special investment funds in the UK allows the UK to be a good place for international provision of management and management adjacent services, whilst providing scope for a UK fund range which does not suffer VAT drag.
- 2.24 The definition of what constitutes 'management' has been subject to significant amounts of litigation and the recent Court of Justice of the European Union (CJEU) decisions have provided more guidance on how it should be interpreted particularly in the context of outsourced functions. However, there is a need for HMRC to give the proper effect to such case law so that for those supply chains that ultimately relate to a special investment fund, no additional VAT cost is suffered purely for the reason that certain functions necessary for the operation of the funds are outsourced. HMRC's position often remains that such outsourced services are taxed, in contradiction to court decisions in *GfBk* (C-275/11), *Blackrock* [2018] UKUT 415,

*Abbey National*(C-169/04) etc. Latest examples (which may well lead to even further litigation) include:



- Clarity on the SIF VAT exemption for research services paid under the MiFID II Directive. A significant current issue for the industry is the availability of the SIF VAT exemption for research services paid under the MiFID II Directive. HMRC's current position has effectively rendered its guidance unworkable in practice and inconsistent with the aforementioned jurisprudence. This position has the result that investment managers are facing significantly increased costs as a consequence of a regulatory change. Businesses urgently need a fair and practical solution as to how the SIF VAT exemption is to be applied to research services.

This matter is of great significance to the investment management industry and the wider eco-system. The lack of a VAT exemption for the supplies in question, based on the position that HMRC articulate, could directly and negatively impact location decisions, as investment managers review their operating models.

- Similarly, the application of the SIF VAT exemption under the principles of the CJEU case in *GfBk* (C-275/11) and more recently the UK Upper Tier Tribunal's decision in *BlackRock* [2018] UKUT 415 to other services used by asset managers and the range of funds they manage needs to be considered urgently. This is important in the context of the competitiveness of the UK compared to other overseas jurisdictions, particularly given other pressures on location choice at the present time.

#### WITHHOLDING TAXES AND ACCESS TO TAX TREATIES

- 2.25 A key selling point for the UK has been that, whilst UK funds are subject to tax, they can benefit from the UK double tax treaty network. Increasingly, the advantage that UK funds hold over funds domiciled offshore on tax treaty access is being eroded by overseas authorities who place practical barriers that prevent treaty benefits from being obtained. Examples include Switzerland and South Korea, both of which require details of beneficial owners, disregarding the fund's entitlement to access the treaty in its own right.
- 2.26 This will become even more important after Brexit if UK funds can no longer access the preferential withholding tax rates that they are currently able to benefit from due to their EU fund status. Territories where this is likely to be an issue for funds include Italy, France, Spain, Norway, Sweden, Czech Republic, Greece and Slovenia.
- 2.27 **The UKFRWG makes a number of recommendations in this area:**
- **An explicit objective for HMRC to maintain protection for UK funds, where tax authorities seek to undermine existing treaty rights for funds.**
  - **An explicit mandate to HMRC to engage positively with overseas jurisdictions with a view to preserving and improving treaty rights particularly where the treaty access issues are likely to arise post Brexit in territories where UK funds have previously not had to rely on tax treaties.**

- **A requirement for all future negotiations to include clear and specific provisions for collective investment vehicles and pension funds (including life companies with solely pensions business) as well as specifically recognise the transparency of the UK ACS.**



## COHERENCE OF REGULATORY FRAMEWORK - CREATING A SINGLE RULE BOOK

- 2.28 Authorised funds are regulated by the FCA and must adhere to the regulatory requirements set out in the FCA's Handbook. These include, *inter alia*, detailed rules in various different parts of the Handbook, known as Sourcebooks, including:
- Collective Investment Schemes Sourcebook (COLL) which covers matters relating to authorised funds such as operating duties and responsibilities, investment and borrowing powers, and investor relations.
  - Investment Funds Sourcebook (FUND) which applies to all UK Alternative Investment Fund Managers (AIFMs).
  - Product Intervention and Product Governance Sourcebook (PROD) rules centre on making firms, including Authorised Fund Managers (AFMs) prove the products they recommend deliver good outcomes, meet the needs of an identifiable target market and are sold to the right clients.
- 2.29 In addition, the FCA Handbook includes eleven key Principles for Business, one of which requires managers of authorised funds to pay due regard to the interest of their customers and to treat them fairly.
- 2.30 The main focus of a fund selection by an international investor will be the investment strategy rather than the structure of the investment vehicle. An international investor will therefore usually opt for a structure and domicile they are familiar with. For a fund domicile to be attractive to overseas investors, it is important they are able to quickly understand and familiarise themselves with the legal structures, legal requirements, regulatory requirements and tax positions of the domicile. The difficulties in having to navigate any complexity in these areas can be enough to deter international investors, even where the outcome is beneficial, for example a more advantageous tax position or more robust regulatory protections. It is therefore important that laws and regulations are reasonably straightforward for international investors, who will not be familiar with local customs and conventions, to understand.
- 2.31 Instead of having many regulatory Sourcebooks for funds, particularly COLL and FUND, **the UKFRWG recommends the Regulator focuses, post Brexit, on creating a single rule book for funds as this will ultimately add to the competitiveness of the UK, especially for overseas investors navigating the UK regulatory landscape.**

## UCITS PLUS



- 2.32 The UKFRWG has considered a fund regime with a similar investor protection standard as UCITS, but with broader investment powers, which we labelled “UCITS plus”. Such a regime could provide a point of differentiation to the UK as a fund domicile, providing a product or a series of products that could service the needs of both domestic and international investors.
- 2.33 A UCITS plus fund regime should offer the investor the protections of UCITS (depository oversight, asset protection, spread limits, disclosure, valuation procedures etc.) but with more investment flexibility, and potentially greater flexibility around operational features to reflect the asset classes in the portfolios, for example, frequency of redemptions. The Non-UCITS Retail Scheme (NURS) already provides the basis for such a regime, allowing investment in a broader range of asset classes than UCITS, including real estate, unregulated collective investment schemes and physical gold, as well as having slightly broader spread limits.
- 2.34 Within the NURS regime are two specialist regimes, Property Authorised Investment Funds (PAIFs) and Fund of Alternative Investment Funds (FAIFs), which provide for investment in real estate and unregulated (alternative) funds, and further flexibility on redemption rights. Under the LTAF proposals in this Report, the UKFRWG proposes that a third specialist regime within the NURS is added, allowing investment in private market investments, including patient capital, private equity, infrastructure and other asset classes that cannot be directly held in existing NURS. The LTAF will offer a suite of funds, with differing investment powers, liquidity and dealing frequencies, but underpinned by the same essential investor protections offered to investors in UCITS.
- 2.35 NURS was designed to meet domestic requirements, in particular offering the ability for UK investors to access asset classes not permitted under UCITS, such as real estate, while ensuring investor protection was maintained. As such, it was never intended for an international audience, and NURS have to date not been sold to an international market. Its unattractive branding reflects this. Nonetheless, with investors increasingly seeking to diversify their portfolios into alternative asset classes<sup>12</sup>, with the right branding the suite of NURS products could appeal to international investors wanting the investor protection offered by UCITS, but with more investment flexibility including exposure to some alternative asset classes. The NURS regime is particularly suited to multi-asset funds for retail investors given the greater investment flexibility.
- 2.36 Beyond proposing the LTAF as a specialist regime within the NURS, we have not proposed any further changes to the existing NURS regime. Instead, the UKFRWG considers that the NURS already has the potential to be an attractive suite of products. **The UKFRWG therefore proposes that the NURS and its subsets be repackaged and rebranded as a ‘UCITS plus’ regime for both the domestic and international market.**

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<sup>12</sup> <https://www.ft.com/content/1167a4b8-6653-11e7-8526-7b38dcaef614>

## MASTER FEEDERS

- 2.37 Master-feeder fund structures have been widely used in the alternative fund space for a number of years as a means of providing gateways for investors to access alternative funds through local or more efficient structures. More recently, UCITS, NURS and QIS have been permitted to adopt master-feeder structures. Although UCITS IV introduced master feeder fund structures for UCITS, take up of these has been limited to date. This is partly due to restrictions on UCITS being able to invest in feeder funds as second schemes. While intended to avoid layering and circularity of investment in second schemes, the restriction within UCITS fundamentally misunderstands the nature of a feeder fund as conceptually a gateway in to the master, rather than a fund of funds.
- 2.38 The UCITS restriction has hampered the development of master feeder fund structures within UCITS, and thus prevented the realisation of the potential of master feeder fund structures. Master feeder fund structures enable investors to benefit from increased economies of scale at the level of the master, the efficiencies of a tax transparent vehicle at master level and cross border pooling of assets, while being able to access these through a familiar local retail friendly vehicle. As the fund is nearly wholly invested in the assets of the master, save for a small proportion that is retained for liquidity or hedging currency risk, an investment in the feeder fund is to all intents and purposes an investment in the master fund, but through a familiar gateway fund structure.
- 2.39 **The UKFRWG believes that master feeder fund structures might be used more widely to allow investors to benefit from increased economies of scale and increased investment choice through being able to access funds domiciled in other jurisdictions (in EU and third countries) through familiar local fund vehicles, i.e. UCITS, NURS or QIS.** In the context of post-Brexit international treaties, master feeder fund structures could also be a key component in mutual fund recognition treaties – funds domiciled in the Far East for example, are unlikely to be attractive to UK retail investors, but these investors may be willing to invest in a UK domiciled fund that invests in a Far East master fund. The master-feeder rules for NURS already provide that NURS feeder funds can invest in master funds that are recognised schemes (under section 272 of the FSMA). **The UKFRWG proposes that this structure should be more heavily promoted as a gateway to opening up funds in other jurisdictions.**

## OPERATIONAL EFFICIENCY



- 2.40 The industry is currently working on a range of operational modernisation projects, which will result in material efficiency gains in a number of areas of the UK funds market, notably on fund switching and fund settlement. There are also other areas under consideration and an IA-led industry working group has identified an optional alternative investor dealing model to the traditional model which is operated in the UK today. This “Direct2Fund” model would facilitate investors transacting directly with the funds and remove the AFM as a counterpart to the investor deal.

### DIRECT2FUND MODEL

- 2.41 In the UK, the traditional fund dealing model operates with the AFM dealing as principal with investors and the investor’s cash flowing through the AFM’s bank accounts. This model differs significantly from the practice in financial centres in Europe and the rest of the world where investors will typically transact directly with the fund itself. The traditional UK model also differs from other financial centres as it exposes the investor to credit risk as the AFM is party to the transaction. The FCA Client Assets (CASS) rules mitigate but do not remove this risk
- 2.42 In the proposed Direct2Fund model, the investor’s cash goes directly to the fund and is received into an Issue & Cancellations bank account. The investor’s exposure to credit risk to the AFM is removed by taking the AFM out of the transaction. The Direct2Fund Working Group has analysed in detail the broad technical considerations for operating a Direct2Fund model. These are contained in the Annex 4. Currently, the Working Group is liaising with the TA Forum (transfer agents) on the day to day practicalities of operating the Direct2Fund model in the UK.
- 2.43 The potential advantages are three-fold:
- Preserve and enhance the protection of client cash, through removing credit risk of AFM.
  - Preserve and enhance the competitiveness of the UK asset management industry and deliver the best possible outcome for investors, business and the UK economy.
  - Replicate as much as possible the model operated in a number of non-UK financial centres.

### BENEFITS OF NEW MODEL

- 2.44 In more detail, a number of benefits have been identified for customers and industry:
- **Lower investor credit risk.** Under the existing principal model, investors are subject to credit risk to the AFM, whereby the bankruptcy of the AFM may lead to financial loss for a subscribing or redeeming investor. The application of Client Money rules for the AFM of collective investment vehicles aims to partially limit those risks; the effectiveness of such risk reduction being dependent on the AFM’s continued adherence to the rules. Under the Direct2Fund model, redeeming investors are subject only to credit risk to the fund from which they



are redeeming. The likelihood of fund insolvency, especially UCITS funds, is minimal in comparison to AFM bankruptcy risk.



- **Improved investor understanding.** Although the role of the AFM as Principal in fund subscriptions and fund redemptions is set out in the prospectus of funds, it is understandable that some investors may not be fully aware of the AFM performing this role. A Direct2Fund model is more representative of likely investor understanding than the Principal model.
- **Enhanced UK industry competitiveness.** The existing Principal model is largely unique to the UK. Given its increased administrative burden, heightened regulatory risk through CASS application and higher AFM capital requirements for unexpected provision of fund liquidity, the UK industry is currently at a competitive disadvantage.
- **Reduced systematic risk.** Under the Direct2Fund model, the insolvency of an AFM, whilst requiring the depositary to identify and appoint a replacement AFM, would not cause direct financial loss to investors. Under the Principal model, investors in the process of transacting, face immediate financial loss risk, resulting in a heightened risk of industry-wide contagion (e.g. directly, if an investor is selling one fund to purchase another or indirectly, through loss of confidence in the financial viability of asset management).
- **Regulatory cost.** Reduced for AFMs as elements of the FCA CASS Sourcebook would no longer apply, and for the FCA through reduced oversight scope.

## RECOMMENDATIONS

2.45 The UKFRWG recognises the potential advantages of the UK operating this alternative model, particularly in the context of a post-Brexit need to preserve and enhance the competitiveness of the UK asset management industry. On the basis that adoption is intended to be optional not obligatory, **the UKFRWG recommends that industry and regulators move ahead.**

2.46 The following key steps are necessary, with full details provided in Annex 4:

- The FCA should consider the regulatory changes proposed by the IA to enable the Direct2Fund model to operate for OEICs. They should elicit the views of other interested parties within the investor dealing model, such as depositaries and transfer agents, when developing modifications to the COLL Sourcebook.
- HMT should review the OEIC Regulations to ensure they are sufficient to enable the FCA to adopt further rules for a Direct2Fund model. Also, HMT should confirm that the proposed record keeping and operational processes for an Issues and Cancellations bank account in the umbrella fund's name meet the protected cell regime requirements.
- ACS and AUT do not have a legal personality so the Issues and Cancellations bank account would be in the name of the Trustee/Depositary. The implications of this would need to be considered by the FCA.



- The ISA Regulations should be reviewed by HMRC to enable funds that permit ISA subscriptions to use the Direct2Fund model.



## RETIREMENT FUND MARKET

2.47 The UK pensions and retirement markets have seen three profound changes in the last 20 years which have re-shaped the entire market:

- The DB-DC shift (a global phenomenon) has meant a greater individual responsibility for pension savings, with investment and longevity risk transferred from employers to individuals.
- In the UK this has been accompanied by the introduction of Automatic Enrolment into employer-sponsored pension plans, with 9.5 million individuals auto-enrolled since 2012<sup>13</sup>. In light of the DB-DC shift, this has been an almost uniquely DC-phenomenon. It has meant a widening of the asset management industry's customer base to include a less affluent and financially confident group.
- This challenge has been amplified by the pension freedoms, which bring more choice and flexibility, but also associated complexity, to customer decision-making.

2.48 In addition to a much wider set of challenges on customers' ability to navigate the pensions and retirement markets, these changes also mean that there is now a real need to re-visit whether the right products are available in the market. The FCA has challenged the industry on this point, highlighting a perceived lack of product innovation in its work on the retirement market<sup>14</sup>.

2.49 In light of these profound changes, the UKFRWG retirement work stream explored what changes, if any, are needed to maximise the relevance and usability of UK investment funds for the fast-growing DC and retirement markets. The Group's full Report can be found at Annex 3.

2.50 Authorised funds play a significant – but relatively indirect - role in the accumulation phase of DC pension saving, which is dominated by life insurance funds, some of which will invest into authorised investment funds. While the use of life assurance vehicles provides benefits to consumers and providers<sup>15</sup>, this "layering" of products also creates some challenges, specifically in relation to the existence of: (i) an additional set of investment rules in respect of life insurance funds; and (ii) an additional set of disclosure rules for life and pensions products. The UKFRWG has considered these issues as part of our report.

2.51 The funds industry may in future play a much more direct role in the provision of retirement income, notably in income drawdown strategies. Historically, this part of the market was relatively constrained given the predominance of DB in workplace pension provision and fairly restrictive requirements on the use of personal or DC

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<sup>13</sup> The Pensions Regulator, 2018, Automatic Enrolment, Commentary and analysis: April 2017 – March 2018.

<sup>14</sup> FCA, 2018, Retirement Outcomes Review Final Report.

<sup>15</sup> These benefits are discussed in Annex 3.

pension saving for anything other than annuity purchase. The Freedom and Choice reforms have resulted in an unprecedented liberalisation of this market, which creates both opportunities and challenges for the fund management industry.



- 2.52 The key issue for the UKFRWG to consider was whether there are features of the regulatory and tax environment that are an obstacle to effective use of investment funds in both the accumulation and retirement phases of DC pensions. These being distinct from commercial practices which may lead to greater use of life-wrapped funds, or approaches to asset allocation / income-generation that do not require funds to act as anything more than individual components within a strategy run by other intermediaries in the delivery chain (notably investment advisers).

## RECOMMENDATIONS

- 2.53 Overall, the UKFRWG has concluded that UK authorised funds are already capable of meeting the needs of retirement consumers to a significant extent. However, as we noted in Part One of this Report, innovation in areas such as 'bond ladders' as a way of generating a stable retirement income may be facilitated longer term by looking again at how income and capital are treated within fund structures.
- 2.54 While outside the scope of this Report, the main challenge for the UK retirement market is the availability of quality advice and guidance for those approaching and in retirement. It is generally felt that the products the fund industry has available can meet the needs of UK retirees; the issue is how these products are combined and managed for individual consumers based on their specific retirement needs.
- 2.55 The UKFRWG recognises that this is a key area of focus for the industry and the FCA which is addressing this challenge, in part, through the Retirement Outcomes Review. The IA will continue to work with its members, regulators and other industry groups to develop the UK retirement market to ensure UK consumers have access to the products and services they need to ensure good retirement outcomes.
- 2.56 In addition to the potential for innovation arising from allowing funds to distribute capital as income, discussed in Part One of this Report, the UKFRWG has identified three challenges in the use of authorised funds in the retirement market and provides recommendations to address them. More detail can be found in Annex 3.
- 2.57 **Tax benefits.** Authorised fund structures do not always allow pension funds to enjoy the tax benefits to which they are entitled. Multi-asset funds will earn interest income which would be exempt of tax in the hands of pension investors but which is subject to corporation tax within the authorised fund. Pension funds operated by life insurance companies can reclaim this tax under existing corporate streaming rules but there is evidence to suggest this is not always done, apparently out of a general lack of awareness of the issue. Other pension vehicles, including many retail pension products, are not able to take advantage of corporate streaming and so suffer tax drag when investing in these vehicles. This issue is becoming more acute as the use of multi-asset funds is growing strongly in both the DC accumulation and retirement markets.
- 2.58 Pension funds are subject to lower withholding tax rates on overseas dividends than UK authorised funds. However, unless an authorised fund is structured specifically as

a tax transparent fund, pension investors in the fund will not be able to claim the reduced rate.



- **The UKFRWG recommends that HMRC should allow deemed deduction for distributions at fund level, which will alleviate the tax drag for multi-asset funds. It will also alleviate the technical challenges for pension funds reclaiming tax in multi-asset funds** (this is discussed earlier on in Part Two of this report).
- In the meantime, pending a change to the tax rules, **the UKFRWG recommends that the IA should work with the Association of British Insurers to further understand why there appears to be a general lack of awareness of the ability of insured pensions to reclaim tax on multi-asset funds, as well as understanding any technical challenges in making these re-claims.** The primary objective will be to ensure that reclaims are being made but it may be that HMRC will need to be approached for another discussion of how the rules and process could be improved to benefit consumers.
- Withholding tax issues will probably be best addressed by individual firm decisions on appropriate fund structure. The benefits of reduced withholding tax vary significantly based on the investment strategy and approach of the asset manager.
- While some asset managers are starting to use tax-transparent funds for defined contribution pension investment, limited investor demand for these vehicles along with the dominance of the life company model are likely to limit the uptake of these vehicles for retirement investors.

2.59 **Role of illiquid assets.** Illiquid investments including private equity and debt, property and infrastructure are well suited to long-term retirement investment. However, it is not straightforward to include these in UK authorised funds suitable for retail investors.

- **The proposed Long-Term Asset Fund constitutes an appropriate way forward and pension providers are encouraged to analyse how they would use the LTAF vehicle. In particular, they would need to ensure they are able to include the fund structure in retirement portfolios without adverse impact to their operational approach or capital requirements.**

2.60 **Layering of legal structures within pensions and retirement products.** Current approaches can result in pension schemes being subject to different and sometimes conflicting rules. The operation of compensation arrangements for pension schemes combining life insurance and investment funds is complex and uncertain. The FSCS has identified the retirement market as a key area of focus in its strategy.

2.61 Disclosure rules, in particular the rules around illustrations and risk warnings, are inconsistent between the regulatory regimes for investment funds and pensions. This reflects a product-driven approach to disclosure and has the potential to confuse

consumers. Given challenges in recent regulatory change, particularly PRIIPs, harmonisation may not be the answer. Rather, there should be an examination of how to ensure a consistent and accessible approach across the retail and pensions markets, with a greater focus on what will most help the customer understand what they are purchasing. The UKFRWG recognises that this is not a simple issue that can be addressed quickly, nonetheless, it is important to address if the retirement market is to work well for customers.



- **The UKFRWG recommends that the IA should further engage with the FSCS to identify and resolve the issues in respect of the compensation arrangements for pensions.**
- **The FCA should over time work to improve disclosure with the objective of reducing or eliminating potential consumer misunderstanding.**

### 3. SUPPORTING COMPETITIVE DELIVERY



- 3.1 Parts One and Two of this Report have identified a series of regulatory and technical measures which can help to enhance the competitiveness of the UK fund regime going forward. They are a necessary, but not sufficient, condition for ongoing success. This requires two additional key elements.
- 3.2 First, enduring political and regulatory commitment to work with industry to promote the UK fund regime internationally, alongside broader efforts to promote the UK asset management industry. This requires a dynamic promotion and branding strategy, many elements of which are already in place, providing strong foundations on which to build.
- 3.3 Second, a framework to ensure that there is an ongoing dialogue between government, regulators and industry about the issues discussed in this paper. Competitiveness and effective delivery is an evolving and ongoing process, not a static one. Since the UKFRWG started meeting, a number of issues discussed in this report have moved further, and it is inevitable that they will continue to do so. New challenges and opportunities will emerge, and there is an obvious benefit from considering a joint institutional framework that can best help to ensure that the open and constructive dialogue between industry, Government and regulator that has characterised the UKFRWG can be maintained.
- 3.4 We set out our proposals on both of these elements in this final section of the Report.

#### PROMOTION AND BRANDING

- 3.5 Promotion is absolutely critical and is as important as some of the more technical changes being proposed in this Report. Having a demonstrable and enduring political and regulatory commitment is what distinguishes a number of other jurisdictions, notably Luxembourg. The UK needs strong consistency, and recognition, of the importance of promotion. Joint efforts between industry, Government and regulators can ensure that the UK marketing brand for portfolio management and fund structures remains compelling, without the UK losing its standing as a well-regulated fund domicile.
- 3.6 Promotion needs to include both promoting the benefits of UK funds for UK investors more widely across the industry, as well as marketing the UK brand internationally. The IA has a history of working with its members, the UK Government and overseas governments to increase market access and provide better opportunities for people to invest. Asset management was identified as a priority by the Financial Services Trade and Investment Board (FSTIB) when it was first set up in 2013, and re-launched after the 2015 UK General Election. FSTIB, led by HM Treasury (HMT), draws together the public and private sector with the Department for International Trade (DIT) and the Foreign and Commonwealth Office (FCO).
- 3.7 FSTIB initiatives such as the Investment Management Strategy have led to the delivery of a number of policy changes and increased the resources for promoting the industry overseas. The industry has benefited from government support in key

markets and in turn provided material for the UK Government's economic and financial dialogues. The DIT One Stop Shop was set up as part of the process to develop and deliver an on-boarding concierge service for high value prospects.



## INVESTMENT FUND FORUM

- 3.8 While the industry may not always agree with every element of regulatory change, there is a broad alignment with the overall direction of travel and a widely held view that the FCA is a robust and innovative regulator with a collaborative approach. The FCA regulatory sandbox and asset management authorisations hub are just two examples of where the regulator aims to offer tools to enhance and streamline firms' experience while maintaining regulatory standards. The UKFRWG welcomes these initiatives.
- 3.9 For the industry to deepen its ongoing relationship with the regulator, there needs to be a closer understanding between asset managers and regulators specifically, thus contributing to the overall goal of strengthening the UK's position from both a domestic delivery and international competitive perspective. **The UKFRWG suggests this could take the form of an 'Investment Fund Forum' which would bring together key participants, including HMT, FCA, the IA and other industry bodies with an interest in fund regulation.**<sup>16</sup>
- 3.10 On an ongoing basis, the Forum would discuss rules, policies, procedures and processes for authorised funds and potential changes to them. Subject to the usual regulatory and policy procedures, this would help facilitate change in a timely manner to remove barriers and help UK fund industry's competitiveness, especially in light of Brexit.
- 3.11 Furthermore, there is a need to build in dialogue with consumer groups, either as part of the above mentioned forum or a separate vehicle.

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<sup>16</sup> This proposal is modelled on a previous iteration, called the Collective Investment Schemes Forum, which brought together industry and regulators.

## NEXT STEPS



This Report has set out a wide range of actions across multiple themes, including regulation, tax and operational efficiency. Taken together, they will make a significant difference to the attractiveness and effectiveness of the UK fund regime for both domestic and international customers

In order to progress and deliver the actions recommended in the Report, a joint approach is needed across multiple players, notably, Government, the FCA and industry. Clearly, a number of proposals will also require a formal policy process. Table 2 overleaf aims to provide clarity on which recommendations are addressed to whom.

In terms of delivery framework, this is a package of measures, designed together to facilitate a more effective market. Given the number of separate proposals, many subject to regulatory development, the timetable will depend in part on regulatory capacity, which we recognise is constrained in the context of Brexit preparation. The industry would like to aim for implementation of the package within 18 months (i.e. by end 2020).

In more detail, some elements of the tax changes and regulatory changes for a Direct2Funds model should be relatively straightforward and could move ahead more quickly. The new fund structures and single rulebook will clearly take longer, but the LTAF and OPF are designed to build on the existing architecture, rather than requiring a new regime per se. Setting up the Industry Fund Forum immediately can allow for the development of timelines, reporting back to the Asset Management Taskforce.

**Table 2: Key Recommendations and Responsibilities for Implementation**

	Government	FCA	Industry
<b>LTAF recommendations</b>	Adapting authorised NURS structure	Changing investment and borrowing powers	To review dealing frequency and change of practice/requirement from platforms to price daily
	Option to list/provide secondary trading of units	Develop investor protection measures	
	Avoidance of additional tax leakage and providing tax incentives	Developing additional liquidity management tools	
		Develop model based valuations	
		Amendments to COLL re registration of assets	
<b>Onshore Alternatives / Professional Regime recommendations</b>	Amendments to tax law	Improvement of QIS rules	Buy-in from trustees/depositary industry for the creation of an unauthorised partnership structure
	Secondary legislation required to establish new fund vehicles		
	Partnership law amendments		
	Development of the ACS structure		
<b>Retirement Fund Market recommendations</b>	Tax – allow deemed deduction for distributions at fund level	COLL amendments to allow funds to make distributions out of capital in addition to income	IA to work with other industry groups to further understand technical challenges of reclaiming tax in multi-asset funds
		FCA to work over time to reduce or eliminate potential customer misunderstanding of pensions disclosures	Withholding tax issues best addressed by individual firms decisions on appropriate fund structures
			IA to further engage with the FSCS to identify and resolve issues on layering of legal structures within pensions and retirement products
<b>Creating a single rule book recommendation</b>		FCA to create a single rule book for funds (merging COLL and FUND)	
<b>Resolving tax inefficiencies</b>	The various recommendations in this section are addressed to both HMT and HMRC		
<b>Direct2Funds Model</b>	Review of the OEIC Regulations to ensure they are sufficient to enable FCA to adopt further rules for the model	Consider regulatory changes to enable the Direct2Fund model to operate for OEICs and where necessary, modify COLL	
		Consider the implications of having the Issues and Cancellations bank account in the name of the Trustee/Depositary as ACS and AUT do not have legal personality	



## ANNEX 1: LONG-TERM ASSET FUND SUB-GROUP REPORT



### CHAIR'S FOREWORD

Evolving investor needs and wider economic trends have resulted in an increasing focus on investment beyond traditional asset classes.

The persistent low interest rate environment has resulted in investors seeking predictable, reliable, long term income looking to alternative sources of yield, including private equity, private debt, real assets and direct infrastructure investments. There is also an increasing desire for diversification beyond public markets and to find ways to reduce portfolio volatility, pursue less correlated returns and gain exposure to the illiquidity premium.

Private capital finance is playing an increasing role in funding both companies and a range of infrastructure and redevelopment projects. The number of companies listed on recognised exchanges is falling, and those that are listing are doing so at a later stage of their growth. Investors who want to access to new and emerging companies are increasingly having to do so while these companies are still private. In addition, investors who want access to infrastructure and real asset investments are faced with a number of structural and regulatory barriers.

In the UK, the Government has signalled its desire to see greater investment by pension schemes and other long term investors into 'Patient Capital' investments, supporting emerging innovative industries that will be the future of our economy.

Our proposals here have been developed with all of these factors in mind.

Our working group has explored how to meet the growing demand for private assets with a robust, investor-focused product framework. While it is possible to structure investment in private assets within pooled vehicles, particularly closed-ended funds, we believe there is a gap in the current product range for a modern, forward-looking UK fund vehicle that is specifically designed and structured to provide a wide range of investor types with direct access to illiquid asset classes. This is particularly true for the DC pensions, private wealth and retirement income markets.

We therefore propose a new structure, known as the "Long Term Asset Fund", or "LTAF".

LTAFs will, in contrast with the product options current available, allow both professional and non-professional investors access to a wide range of private market investments.

The LTAF can be established as a sub-category of the UK Non-UCITS Retail Scheme (NURS), leveraging many of the features already available in the NURS, but with a broader set of investment powers (i.e. the ability to invest in the full range of illiquid asset classes) and provision for less frequent dealing (as daily dealing is not realistic for funds investing in highly illiquid assets), among other attributes.

We hope that our proposals provide a clear blueprint for the new vehicle. In serving its investors, the asset management industry is key to channelling private capital into the economy. We are keen to embrace the opportunity to support companies, the real economy and infrastructure projects, whilst providing a wider range of investors with the opportunity to access, subject to robust protections, a broader range of investments which complement their existing portfolios.

I would like to thank the members of the LTAF working group for their contributions, and to recognise the significant technical contribution provided by Lora Froud of Macfarlanes LLP, to the report.

**Alex Cunningham, Chair, Long Term Asset Fund Working Group**

### INTRODUCTION



1. The Long-Term Asset Fund (LTAF) Working Group is a sub-group of the UK Funds Regime Working Group (UKFRWG).
2. The objective is to identify the features required for a UK investment fund specifically investing in long-term illiquid assets or patient capital<sup>17</sup>. The objective is to allow investors better access to these investments, within pensions, as part of multi-asset or guided architecture products or services, or as part of their personal portfolios.
3. For the purposes of this Annex, patient capital will include non-listed investments typically with a long investment horizon such as real estate, private equity, infrastructure, venture capital and private credit, in line with the definition provided by the FCA in its discussion paper on patient capital.
4. Membership of the group draws on a wide range of experience across different parts of the market.
5. Input was gathered through group meetings and one-to-one discussions with a range of stakeholders. We have also sought to coordinate closely with other initiatives looking at similar areas covered in the Report.

### UK INVESTMENT FUNDS AND PRIVATE MARKETS

6. While structures exist for traditional institutional investors to effectively access illiquid investments, the nature of the UK savings and pensions market is rapidly changing and the demand for suitable open-ended fund products is growing<sup>18</sup>. Investment trusts already provide a valuable solution for investors wanting closed ended structures, but target investor groups, particularly DC pension investors, are seeking investment vehicles that reflect the values and volatility profiles of the underlying investments for the purposes of reducing correlation with other asset classes.
7. There is a second important requirement. Significant parts of the DC pensions market and wealth management markets tend to invest in funds that are authorised and suitable for retail investors. This is because of the robust governance and customer protection offered in the context of a distribution process that has strong retail market characteristics. Looking ahead, there may also be much stronger demand within the traditional advised retail market itself for a product that offers investors a very different risk/return profile from more liquid asset classes.
8. None of the three categories of authorised funds (UCITS, NURS and QIS) are truly suitable, in their current form, for retail investors to gain access to private market investments. Although a UCITS is available to retail investors, the investment restrictions applicable to a UCITS under COLL make it unsuitable given that it is

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<sup>17</sup> In its consultation “Financial Growth in Innovative Firms”, HM Treasury defined “Patient Capital” as “long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses”.

<sup>18</sup> An open-ended product is where units in the fund can be created and cancelled at defined intervals to meet investor demands to buy and sell units redeemed at any time, as opposed to closed ended where all units of the fund are issued at the outset.

primarily restricted to investments in listed investments and other UCITS and NURS, meaning there is little scope to access private market investments.



9. Whilst a QIS has sufficient investment flexibility to allow it to access private market investments, its unsuitability for retail investors, other than sophisticated investors, means it is also unlikely to be an option for the DC market, despite the FCA's proposed changes to the permitted links rules. Although the QIS structure could be useful for certain types of wealth managers with professional clients, their high net worth clients are typically categorised as retail investors, who will not always be classed as sophisticated investors. Private wealth managers are generally reluctant to recommend or invest in QIS on behalf of these clients, particularly since QIS are classed as Non-mainstream Pooled Investments (NMPs), which are subject to strict suitability requirements intended to prevent these being sold to retail investors other than those considered to be sophisticated.

### NURS AND ITS LIMITATIONS

10. The only one of the three categories of authorised funds which offers any potential solution for retail investors is the NURS. The NURS was primarily designed to hold investments in listed securities, regulated collective investment schemes and property, and the investment powers, spread rules, pricing and redemption frequency rules have been designed around these asset classes. The Fund of Alternative Investment Funds (FAIF) structure allows for greater investment in unauthorised collective investment schemes. This structure can be used to engineer a portfolio that provides access to private market investments; but this is a complex and costly structuring process. Without this structuring, the current NURS' suitability is limited in a number of ways:

### INVESTMENT POWERS

11. **Investments in collective investment schemes.** For a "standard" NURS, no more than 20% of the portfolio may be invested in unregulated limited partnerships. As most private market investments tend to be held through unregulated collective investment schemes, this restriction clearly limits the scope for such investments by a NURS. However the restriction was relaxed when the FAIF regime was introduced. A NURS FAIF can invest up to 100% in unregulated collective investment schemes provided no more than 35% is invested in any one such scheme. The funds we have seen established in this market to date have been launched as NURS FAIFs in order to take advantage of this additional flexibility.
12. **No direct investment in limited partnerships.** Most private market investments are held through a limited partnership. Pursuant to COLL, a NURS cannot invest directly in such a structure as it cannot redeem at NAV. Managers are therefore having to introduce layers of intermediary vehicles to access private market limited partnerships; either through an open-ended collective investment scheme or through a corporate vehicle.
13. **Second Scheme.** A NURS is further restricted in that it cannot invest in another collective investment scheme which itself invests more than 15% of the value of the scheme property in units in collective investment schemes. As such, if an open-ended collective investment scheme is used in the portfolio, its further investment in private market limited partnerships is limited.

14. **20% unlisted securities limit.** As mentioned above, a NURS could access private market investments via a corporate vehicle. However a NURS cannot invest more than 20% of the fund's scheme property in unlisted shares and no more than 10% in the shares of any one issuer. This makes access to private market investments via corporate structures challenging too. We have seen managers negotiate this by investing in collective investment schemes which in turn invest in corporates, which in turn hold the private market limited partnership investments, or private market investments directly. This restriction also makes it challenging for managers to access senior loans, which are often desirable as part of the private market portfolio, but which are often unlisted.
15. **Inflexible Spread and Diversification Rules.** NURS set strict limits on the percentage of the fund that can be held in each asset, and in some cases each asset type. These require inadvertent breaches of these limits, such as those due to market movements, to be corrected as soon as practicable in the best interests of investors, in any event within six months. It will not always be possible to arrange a sale of an illiquid asset at a competitive price within six months. In addition, if a position consists of a single, indivisible asset, it may only be possible to correct the position by divesting the entire asset rather than a partial divestment to reduce the size of the position, depriving the fund of all exposure to that asset. NURS are currently permitted a derogation period after launch of up to six months where the full spread rules do not apply – it is unlikely to be possible for funds to be fully invested in illiquid assets in this time.
16. **Limited Borrowing Powers.** A NURS' borrowing cannot exceed 10% of the value of the scheme property of the fund on any day. The borrowing abilities of a NURS are therefore inadequate for a fund requiring greater borrowing capacity in order to access private market investments. However, typically some borrowing can be incorporated lower down in the structure.
17. **Cannot guarantee.** A NURS cannot provide any guarantee or indemnity in respect of the obligations of any person and none of the scheme property of a NURS may be used to discharge any obligations arising under a guarantee or indemnity with respect to the obligations of any person. This is restrictive because, if a manager wants to introduce some borrowing somewhere in the portfolio structure, there are restrictions on the ability to use scheme property as security for that loan. It is not clear whether that restriction on using scheme property as security relates only to direct scheme property of the NURS, or whether it means all indirect scheme property held within the structure somewhere.
18. As is noted in the main report, it has been possible for some providers to use the existing NURS FAIF to manage private investments. However, this has been achieved through the establishment of additional underlying fund and corporate structures, nearly all domiciled in offshore jurisdictions, particularly Ireland and Luxembourg. Such restructuring creates additional costs and reduces portfolio visibility in addition to channelling investment through offshore investment vehicles rather than UK structures.

### DEALING FREQUENCY

19. We understand that the DC market and the platforms require daily dealing products, although they are able to accommodate deferrals and limited redemptions in

extraordinary market circumstances. Even where funds are launched with a private market focus for the private wealth management space, wealth managers require them to be daily dealing. There is no legal or regulatory reason why; we believe this issue to be platform/market driven. We consider that more work should be done in trying to understand whether there is an operational / practical reason why the platforms cannot accommodate less frequent dealing.

20. There is a requirement that valuations must be at least fortnightly in COLL 6.3.4R (1). COLL 6.2.16R requires that sales and redemptions are priced at next VP (i.e. at least fortnightly), unless limited redemption applies. But to date, platforms have generally not been willing to contemplate allowing weekly or fortnightly dealing funds, let alone less frequent funds, so that is ultimately the main barrier, to having non-daily dealing funds.
21. The current ISA rules also require all funds to be priced at least fortnightly. As personal investment portfolios are largely held in ISAs, the ISA rules will also be a barrier to funds with less frequent dealing than fortnightly.

### LIQUIDITY MANAGEMENT TOOLS

22. The tools available to managers of UK UCITS and NURS experiencing large redemptions are limited, and generally full suspension of dealing is the only tool considered to be of any practical value. Although fair value pricing and dilution levies and adjustments are important investor protection tools used in market dislocations that can result in large redemptions, these are not considered by the IA to be tools to manage liquidity – their purpose is to ensure that exiting investors receive a price that reflects the sale value of the underlying assets, rather than restrict or reduce the flow of redemptions.
23. Deferred redemptions are permitted under COLL, but the rules only permit redemptions to be deferred until the next dealing point, which for a fund that offers frequent dealing is of limited use given that a considerably longer period is likely to be needed to raise liquidity in the fund. Discretionary exit fees, which are only applied by the manager to discourage redemptions during times of market stress are permitted, but these are undesirable as they both penalise exiting investors (beyond merely reflecting the realistic realisation costs of the underlying assets) and are generally not high enough to deter investors wanting to exit “at any cost”.
24. Suspension is an effective tool for managing large redemptions where this is required, and serves an important function in stressed periods in ensuring the interests of existing investors are protected by avoiding sales of only relatively liquid or high quality assets, and avoiding firesales at less than market value of less liquid assets. Nonetheless, suspension of a fund is highly disruptive as it prevents inflows during the period of suspension as well as outflows. Suspending funds can have reputational implications. Although suspension will be an important tool for LTAFs, particularly where alternative options for managing redemption volumes have been exhausted, other less drastic liquidity tools are also likely to be required for a fund investing predominantly in long-term, illiquid assets.

### REGISTRATION OF ASSETS

25. COLL 6.6.12R (for UCITS and NURS) and COLL 8.5.4R (for QIS) requires non-financial instruments to be registered in the name of the depositary, increasing the

cost of transferring title and impacting depositaries in areas such as environmental and health and safety legislation, and drawdown commitments for partnership interests. We understand this requirement is already a concern for many depositaries in respect of property funds, and the further challenges of being the registered owner for the wider range of long-term private assets proposed may deter depositaries from being willing to act for LTAFs, thus having implications on the ability for asset managers to bring innovative products to the market.

26. As highlighted in the above, although a NURS offers the only potential option of the three types of authorised funds available, there is still currently a need to do some complex structuring to create a private market investments portfolio that works within the COLL restrictions. This structuring results in additional costs and decreased transparency for investors. Any portfolio constructed must also have regard to the liquidity management requirements, explored below. As such, creating a more flexible investment and borrowing power regime required to enable investments in long-term assets only works if more flexibility is introduced in liquidity management options; as the two go hand in hand.

### PROPOSAL FOR A UK LONG-TERM ASSET FUND

27. The subgroup has considered existing fund structures, or whether a new fund structure was needed. The advantages and limitations of existing structures are discussed in detail at the end of this annex.
28. Various target investor groups, particularly DC pension investors, expressed a preference for an open-ended fund structure over a closed-ended structure. DC pension investors have large monthly inflows, which need to be invested quickly to maintain target investment allocations without distorting the price per unit of the fund. They also want returns that reflect the values and volatility profiles of the underlying investments for the purposes of reducing correlation with other asset classes, noting that listed closed ended funds such as investment trusts tend to give an equity-like return profile.

### ADAPT NURS REGIME

29. All existing authorised fund structures have limitations as vehicles for investing in long-term and patient capital assets. Nonetheless, the sub-group has concluded that an entirely new fund structure is not required. Instead, it proposes the NURS rules can be adapted to accommodate a new subset for the LTAF, operating much like the existing sub-set of NURS, the FAIF but with additional flexibility around the rules on investment and borrowing powers, dealing frequency, liquidity management tools and valuation of investments. We explore these areas in more detail in the proposal. A new sub-set of the NURS rules would also create an identifiable fund category, which would ensure investors can identify the long term nature and the consequent commitment of their capital in the fund, and distinguish this from more mainstream NURS offerings. It would also enable the government to provide additional incentives to invest, such as tax benefits.
30. While the overall structure of the ELTIF has not proved appealing for investors or manufacturers, there are some features from the ELTIF regime that are attractive. In particular, we consider the concept of some of the protections relating to retail investors to be helpful, specifically, the requirement to ensure that investors have



received advice that the product is suitable for them. If the LTAF is going to include more flexible dealing options (for example, if it could be possible to have dealing restricted for over a year), these could be useful features to be considered. We suggest looking at how the principles can be used in a flexible manner. It might be helpful to have a two tiered system, dependant on levels of liquidity offered to investors, when considering whether to apply these types of features to the LTAF. For example, if investors are unable to withdraw their investment for a significant amount of time, perhaps if they are locked in for over two years, then protection such as investment advice and/or limits on the amount of their portfolio which can be invested in the LTAF are applied. In contrast, if they are able to redeem more frequently than, say, every two years, these additional protections are not applied and instead the MiFID II investor protection safeguards are considered sufficient.

31. A common label for marketing purposes will also be important. With suitable promotion and investor education, this will assist with ensuring that intermediaries and investors can readily identify the long-term nature of the fund and distinguish the LTAF from other types of NURS.
32. The ELTIF rules also allow investment in a wide range of unlisted and listed small company assets, including quasi equity, quasi debt securities and loan origination. The LTAF will benefit from similar investment flexibility.

### BESPOKE INVESTMENT AND BORROWING POWERS DESIGNED FOR ILLIQUID INVESTMENTS

33. For LTAFs to be attractive, these will require the ability to invest efficiently in long-term assets, and to be fully invested in these asset classes in order to give a commensurate return. Restrictions on the overall amount the LTAF can hold in long-term assets, e.g. for the purposes of ensuring liquidity, would dilute the return provided to investors from the long-term investments, making this less attractive as a component investment in a diversified portfolio (which will mostly consist of liquid investments). The investment and borrowing powers of LTAFs will need to reflect the diverse nature and characteristics of long-term investments, ranging from unlisted equity in early stage companies to private debt in large infrastructure projects.
34. The key areas for increasing flexibility in terms of investment and borrowing powers to enable investment in long term assets are relaxing the restrictions on investments in limited partnerships, restrictions on the second scheme, the use of the unlisted securities limit and the borrowing/guarantee provisions.
35. These broader investment and borrowing powers will be necessary to allow for more direct investment in long-term investment. To ensure investors are properly protected, these should be underpinned by a requirement for the LTAF to undertake appropriate due diligence and risk management on the assets to which investors are exposed, and to apply a prudent spread of risk.

### **Allow up to 100% to be invested in unauthorised collective investment schemes.**

36. Investments in collective investment schemes – most private market investments tend to be held through unregulated collective investment schemes. Similar to a FAIF, an LTAF will need to be able to invest up to 100% in unregulated collective investment schemes.

### **Allow direct investment in limited partnerships.**

37. Direct investment in limited partnerships – most private market investments are held through a limited partnership. An LTAF investing in early stage companies is likely to want to access these through venture capital funds, which are also typically structured as limited partnerships. It is therefore important that an LTAF can invest directly in limited partnerships as well as other forms of collective investment schemes. This will avoid needing to introduce costly and less transparent layers of intermediary vehicles to access private market limited partnerships, either through an open-ended collective investment scheme or through a corporate vehicle.

### **Dis-apply second scheme restriction on collective investment schemes.**

38. The requirement for a second collective investment scheme to have a restriction on itself investing more than 15% of the value of the scheme property in units in collective investment schemes should not apply to LTAFs. Local collective investment schemes are often the most tax efficient way to access private investments in overseas jurisdiction, and some of the underlying investments themselves may be structured such that they constitute collective investment schemes. Such a restriction will therefore act as a barrier to LTAFs accessing certain investments.

### **Allow up to 100% to be held in unlisted securities.**

39. The overall proportion of the LTAF that can be invested in private (unlisted) securities should be unrestricted. Investments are unlikely to be made directly in infrastructure – these investments will normally be accessed through unlisted equity or unlisted debt. Many early stage companies will not be listed, therefore direct investment in these will require the LTAF holding unlisted equities. LTAFs may also find it efficient to access private market investments via a corporate vehicle. LTAFs will also need to be able to access senior loans, which are often desirable as part of the private market portfolio, but which are often unlisted.

### **Spread and diversification rules that are appropriate to the illiquid nature of the asset classes.**

40. Diversification has two aims prudent spread of risk and access to liquidity. The first is clearly relevant here in the context of long term assets but the second is less so if the fund is designed to be a long term play.
41. As a retail product, spread limits will be required to ensure appropriate diversification, particularly at the point of investment or capital commitment. However, on an ongoing basis it will be less straightforward for these assets to be divested or positions to be reduced in reaction to changes in fund size, relative valuations and market conditions. We therefore suggest that the spread limits include capacity for particular assets to exceed the limits where these occur due to a change in valuation (rather than an active investment decision), at least for an appropriate time period, and provided the positions are not added to while they exceed the spread limits.

### **Allow a wider range of derivatives to be held for hedging purposes.**

42. LTAFs may need to hedge against a broader range of risks given the nature of the underlying assets, for example the possibility of adverse weather conditions



disrupting an infrastructure project which the fund has an investment in. Derivatives beyond those usually permitted for NURS should be permitted provided these are for the purposes of hedging an identified risk in the portfolio. Similarly, the LTAF should have the ability to take insurance contracts against identifiable risks in the portfolio or related to the management of assets in the portfolio.

### **Ability to originate or participate in loans.**

43. Many private investments, particularly in infrastructure products, are structured in the form of loans. The ability for an LTAF to lend / originate loans, or participate in loans, will be necessary where securitisation of debt is not available or is more expensive. This power will need to be subject to the manager retaining the appropriate expertise in credit assessment and due diligence required for direct lending or (more likely) partnering with a credit institution with these capabilities.

### **Extended borrowing capacity to enable private transactions.**

44. A fund accessing private market investments is likely to require greater borrowing capacity, on a temporary basis, to assist with making of the investments and also bridging redemptions. The enhanced borrowing powers are for the purposes of facilitating transactions, and the LTAF rules should prevent borrowing being used to introduce gearing into the fund.

### **Ability to guarantee loans.**

45. An LTAF will require the ability to provide a guarantee or indemnity in the case of certain transactions. If a manager wants to introduce some borrowing somewhere in the portfolio structure, it may be necessary to use scheme property as security for that loan. The ability to provide a guarantee or indemnity against scheme property will need to be subject to strict conditions and limits to ensure investor protection is not compromised.

### **Initial investment period after launch**

46. The time permitted after launch before the LTAF is required to be fully compliant with the investment spread rules will need to be considerably longer than for conventional NURS. Identifying suitable private market investments and completing the investment of these can take considerably longer than for conventional assets. In the case of certain asset classes, particularly private equity and venture capital, investing may involve committing capital that is not drawn on immediately, but is called upon over a period following investment. As such it is likely to be between 2 and 5 years before an LTAF can be fully invested.

### **Ability to invest in listed transferable securities, authorised funds and liquid assets.**

47. Although the primary aim of an LTAF will be to give investors access to private market returns, as noted above, there is likely to be a long period following launch before the fund can be fully invested in private market investments. During this period, and also for subsequent periods where liquidity becomes available in a LTAF (e.g. on receipt of subscriptions, or through the disposal, realisation or maturity of a private investment), it may be helpful for the manager to be able to invest this liquidity where investment objectives and policies allow, in complementary

conventional securities, funds or money market instruments which can be accessed and disposed of more quickly, to maximise investment returns until further private market investments are made. Some LTAF providers may also wish to combine private market investments with conventional asset classes for the purposes of providing a diversified investment portfolio, or greater liquidity. As such, we recommend that LTAFs are allowed to invest in conventional listed transferable securities, authorised funds and liquid investments alongside illiquid private market investments, where this is consistent with the investment policies.



### DEALING FREQUENCY ALIGNED TO THE LIQUIDITY OF THE UNDERLYING ASSETS

48. While the LTAF will be for investors with long term time horizons, we anticipate investors will in most cases want the opportunity to redeem during the life of the funds. The dealing frequency will need to be consistent with and aligned to the liquidity of the underlying assets, which suggests a lower dealing frequency than is normally associated with authorised open-ended funds, subject to any platform or operational issues being solved. We envisage most LTAFs are likely to want dealing frequencies that are monthly, quarterly or half-yearly, though some LTAFs may require annual or longer periods between dealing points. Some LTAFs may elect to hold a portion of assets that can be sold quickly to allow for more frequent redemptions.
49. The rules for LTAF will therefore need to permit less frequent dealing points than the current minimum dealing frequency of twice a month for conventional NURS.
50. As noted above, platforms for DC and other investors typically require funds to offer daily dealing. While there are no regulatory barriers to platforms offering less frequent dealing points, platforms will need to make changes to their software infrastructure and operational processes, which will require investment on their part. It is possible platforms may need to be incentivised to make this investment before LTAFs with lower dealing frequencies can be brought to market.
51. Liquidity is primarily a concern for managing redemption requests. Assets sold in the fund will usually need to be sold to meet high levels of redemptions, which in the case of illiquid assets can take a number of months to effect, depending on the nature and size of the asset, the buyers available and the legal process involved in transferring ownership. Redemption frequency will therefore need to be aligned to the liquidity of the underlying assets, but an LTAF manager may be comfortable that it can offer more frequent subscription points, e.g. monthly subscription points, and quarterly redemption points, and the rules for LTAF should allow for more frequent subscription points. That said, it should be noted that completing purchases of certain illiquid asset classes can also take many months, and be dependent on the pipeline of investments available, so the manager will need to take this into consideration when setting a subscription frequency.
52. A lower dealing frequency need not prevent indicative valuations being provided on a more regular basis, where this is required by specific investor groups.
53. The current ISA rules also require all funds to be priced at least fortnightly. As personal investment portfolios are largely held in ISAs, the ISA rules will also be a barrier to funds with less frequent dealing than fortnightly.

### STRONG INVESTOR PROTECTION MEASURES

54. If redemptions were going to be more infrequent than is currently possible, for example, every two years, then perhaps that would trigger requirements similar to those in the European Long-Term Investment Funds (ELTIF) regulation such as appropriate investment advice needing to be taken and/or limit on the amount of an individual's assets/pension pot which can be invested in the fund. Any proposals in this regard would need to be practical for both manufacturers and intermediaries

### OPTION TO LIST/PROVIDE SECONDARY TRADING OF UNITS

55. More frequent dealing could also be provided through listing, or other secondary exchanges such as matching services. The option to list would, if utilised, provide investors with an opportunity to at least transfer their investment on the secondary market if they wanted liquidity during a deferred or limited redemption period, rather than having to wait until a redemption day. Non-listed secondary exchanges of units should also be permissible. The approval of such mechanisms should be subject to the manager being able to demonstrate that pricing and transfer can be delivered in a manner that is fair to investors.

### LIQUIDITY MANAGEMENT

56. The ability to be able to manage redemptions in a way that is fair to all investors will be important, given the illiquid nature of the underlying investments of an LTAF. Primarily, the manager should be required to have a robust liquidity management process ensuring that for anticipated subscription and redemption flows liquidity can be managed effectively and in line with the redemption terms of the LTAF in normal market conditions. This is the case for all authorised funds, although strong regulatory focus would be anticipated on the liquidity management policy for LTAFs given the taking into consideration the nature of the underlying assets. There may, however, be periods where redemptions are higher or liquidity is lower than in normal conditions, and therefore appropriate tools to protect the interests of remaining investors will be required where liquidity is not available.
57. Although suspension as a tool works well where it is required, this is highly disruptive as it prevents inflows during the period of suspension as well as outflows. Suspension should not therefore be the only tool available to manage large redemptions. It is important that a wider toolkit is made available to LTAFs to manage liquidity, as outlined in our responses to the FCA's consultations DP17/1 and CP18/27 on Illiquid Investments in Open-ended Investment Funds. More guidance is needed from the FCA on deferred and limited redemption mechanics. LTAFs may need to use the ability to limit or defer redemptions for longer periods than six months, while continuing to allow inflows.
58. We consider that more use could be made of the deferred and limited redemption mechanics if there was more guidance from the FCA around its expectations and / or some investor protection safeguards were built in to the process. For example, in our opinion, perhaps it would be acceptable to use limited / deferred redemption to limit / defer dealing for longer periods than six months, provided investors were appropriately advised and limited in the amount of their portfolio which could be invested in the NURS. This would be the way to incorporate the beneficial provisions from the ELTIF regulation.

59. It is also important that LTAFs are able to use notice periods for redemptions. Feedback from members suggests that an LTAF could allow for relatively frequent dealing, provided a suitable notice period was given for redemptions, allowing the manager sufficient time to sell relatively illiquid assets for a suitable price, or to accumulate sufficient funds from inflows to meet the redemption requirements.
60. Other liquidity management tools could also be considered, such as the ability to suspend redemptions only (i.e. continue to allow sales), the ability to “gate” (subtly different to deferred redemptions), or permitting a redemption fee for those who come out before the recommended holding period.

### MODEL BASED VALUATIONS

61. Market prices are rarely available for long-term assets such as private equity, private debt, real estate, etc. Also unregulated funds that invest in these assets, such as private equity funds, private debt funds, and venture capital funds, do not value frequently – this can be as infrequent as once a year.
62. Therefore, the manager of an LTAF will need to use a pricing model, considering a range of economic information relating to both the particular asset concerned and the wider market. This is likely to be an involved process, and may require the use of an external valuer such as a property surveyor, and so will not be practical to undertake on a daily basis. Monthly or quarterly valuations will be more realistic. Where daily or weekly dealing is used, or (in the case of less frequent dealing) indicative valuations are provided on a more frequent basis, the valuation is likely to be based on a less frequent full valuation, with daily/weekly adjustments made for accrued income, inflows and outflows, purchases and sales of assets. This is similar to the valuation process used for NURS investing in property.
63. Such a valuation model will be similar to fair value pricing where the fund manager believes on reasonable grounds that:
- No reliable price exists for a security at a valuation point; or
  - The most recent price available does not reflect the manager’s best estimate of the value of a security at the valuation point.
64. However, unlike fair value pricing, where the process and inputs usually have to be adapted to reflect the market conditions that have led to this being invoked, and the information that is available, the valuation model for the LTAF will be based on a pre-defined methodology that is pre-disclosed to investors. The valuation process will depend to a large extent on the types of assets the LTAF invests in, how regularly it is valued and its dealing frequency.

### REGISTRATION OF ASSETS

65. COLL 6.6.12R and COLL 8.5.4R should be revised for LTAFs and QIS to allow private market investments to be registered in the name of the AIF or the AIFM acting on behalf of the AIF, subject to appropriate protections to ensure assets cannot be sold without the knowledge or consent of the depositary, as opposed to the current FCA requirement for non-financial instruments to be registered in the name of the depositary.

### TAX EFFICIENCY

66. It is important that the LTAF should not give rise to an extra level of tax which increases leakage for investors compared to their position had they invested directly.
67. The tax regime for LTAF should be designed such that it does not give rise to additional tax leakage at the fund level. The nature of alternative investments by an LTAF would involve use of special purpose vehicles and international structures, which almost certainly necessitates measures beyond the existing tax regime for AIFs. In addition, a competitive VAT regime for management of such a fund would be critical for its success as a suitable alternative to other similar non-UK structures. The current VAT treatment of UK AIFs compares poorly to the VAT treatment of offshore alternatives. Hence it will need to be reviewed to ensure that VAT treatment of LTAFs is on an equivalent footing to offshore alternatives. Seeding relief would be required and it will be important that the LTAF can be seeded by one investor.
68. Seeding relief would be required and it is important that an LTAF can be seeded by one investor.

### TAX INCENTIVES

69. We recommend that HMT explores the option of providing for a break akin to VCTs/EIS for investors in LTAFs investing in particular assets perceived to have a public benefit (e.g. public infrastructure, early stage investments, social projects) if investors invest for longer periods. The Group believes that the introduction of tax incentives for investors who remain invested would both encourage investors to provide funding to Patient Capital and provide an incentive for investors to remain invested through difficult periods.
70. We also recommend that the ISA rules on qualifying investments are amended to allow LTAFs to be held within ISA portfolios so these can be utilised in the ISA portfolios of clients of discretionary wealth managers and advisers. We note in recent years that changes have been made to the ISA rules to accommodate highly illiquid assets such as peer-to-peer loans and crowdfunding investments into Innovative ISAs, and therefore believe there is a similar case for allowing LTAFs to be held in an ISA wrapper.

### PERMITTED LINKS RULES

71. NURS are currently permitted within the definition of “permitted scheme interests”. If the LTAF is included as a sub-set of the NURS rules, these would therefore be included as permitted links. However, the FCA’s proposed changes to the permitted links rules<sup>19</sup> could create some issues for LTAFs within a unit-linked framework as a result of the proposed 50% limit on illiquid assets in unit-linked funds. The IA has responded separately<sup>20</sup> to the consultation on permitted links, but it is important that LTAFs are available to insurance based pension funds without restriction.

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<sup>19</sup> CP18/40: Consultation on proposed amendment of COBS 21.3 permitted links rules, FCA 2018.

<sup>20</sup> [IA response to CP18/40](#), 2019.

### TARGET/ELIGIBLE INVESTOR TYPE



72. From discussions with both asset managers and potential investors, the anticipated target market covers the following customers:

- **DC market:** particularly DC default schemes wanting to make an allocation to long-term investments to provide diversification and the potential for uncorrelated returns. DC schemes typically take two forms:
  - Trust-based schemes can access non-insured funds as professional investors because the scheme trustees are treated as professional clients under FCA rules. However trustees generally feel more comfortable with selecting retail funds.
  - Insurance-based: any DC scheme accessing investments through a unit-linked insurance contract must look through to the underlying investor, the retail client. In the unit-linked world, the investment must therefore be suitable for retail investors.
- **Private Wealth/Discretionary Portfolio Manager:** there is interest from these groups in the potential for diversification into a broader range of asset classes. While the clients of private wealth managers are typically high net worth, they are nonetheless usually still classified as retail investors, and therefore there is a preference in this audience for retail funds.
- **Professional investors:** these include institutional investors such as pension schemes, sovereign wealth funds, etc. These have flexibility to choose between a wide range of investment options in long-term investments, including direct, unauthorised funds (including offshore and onshore funds), authorised funds for professional or sophisticated investors such as QIS, QIAIFs (Ireland), or SIFs (Luxembourg), in addition to retail funds.
- **Multi asset funds/fund of funds:** These are usually authorised funds that seek to provide diversified, uncorrelated returns, often within a targeted risk range. The potential of diversification and uncorrelated returns from an allocation to long-term investments is likely to be attractive to managers of these funds. While these are generally considered professional investors, fund regulations usually restrict these to investing either predominantly or exclusively in authorised funds.
- **Local Government Pension Scheme (LGPS) investors:** The LGPS is currently going through a Government-mandated pooling of its assets. However, LGPS investors have thus far been unable to find a way to pool illiquid assets in current authorised fund structures and so would benefit from access to the LTAF, which would offer a way to pool illiquid assets in a manner consistent with the Government's requirements for the LGPS.

73. To be able to access these target investor groups, we consider that the LTAF should be capable of being promoted to retail clients, though subject to the restrictions of a complex product. This is particularly important for the DC market, but is often a feature required for other investors such as wealth managers and multi asset funds.

74. Some interest is possible from advised retail investors with larger portfolios, who may be recommended a small allocation to long-term investments as a satellite

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component of a wider investment portfolio. However, the IA anticipates that the LTAF will be a complex product for the purposes of distribution to retail investors under MiFID II, and therefore does not expect the LTAF to be directly marketed to the wider retail market.



## TABLE OF RECOMMENDATIONS



<b>Long-Term Asset Fund</b>	
Objectives	Identify the features required for a UK investment fund specifically investing in long term illiquid assets, including patient capital, private assets, real estate, infrastructure, etc.
Deliverable	Propose a set of recommendations to allow such a product to be created.
<i>Key recommendations</i>	
Investor type	<p>Capable of being promoted to both retail and professional investors:</p> <ul style="list-style-type: none"> <li>• DC market: <ul style="list-style-type: none"> <li>○ Trust-based schemes can access non-insured funds as professional investors because the scheme trustees are treated as professional clients under FCA rules</li> <li>○ Any DC scheme accessing investments through a unit-linked insurance contract must look through to the underlying investor, the retail client.</li> </ul> </li> <li>• Private Wealth/Discretionary Portfolio Managers</li> <li>• Professional Investors</li> <li>• Multi-asset funds/fund of funds</li> <li>• Advised/sophisticated retail</li> </ul>
Adapt existing authorised NURS structure	<ul style="list-style-type: none"> <li>• Open-ended fund (closed ended solutions already exist)</li> </ul> <p>Don't need a new fund structure; a new sub-set of NURS – operating much like the existing sub-set of NURS, the FAIF but with specific investment and borrowing powers, and lower frequency dealing and valuation periods permitted.</p>
Bespoke investment and borrowing powers designed for illiquid investments	<ul style="list-style-type: none"> <li>• Allow up to 100% to be invested in unauthorised collective investment schemes.</li> <li>• Allow direct investment in limited partnerships.</li> <li>• Dis-apply second scheme restriction on collective investment schemes.</li> <li>• Allow up to 100% to be held in unlisted securities.</li> <li>• Spread and diversification rules that are appropriate to the illiquid nature of the asset classes.</li> <li>• Allow a wider range of derivatives to be held for hedging purposes.</li> <li>• Ability to originate or participate in loans.</li> <li>• Extended borrowing capacity to enable private transactions</li> </ul>



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	<ul style="list-style-type: none"> <li>• Ability to guarantee loans.</li> <li>• Initial investment period after launch</li> <li>• Ability to invest in listed transferable securities, authorised funds and liquid assets.</li> </ul>
Dealing frequency aligned to the liquidity of the underlying assets	<ul style="list-style-type: none"> <li>• Discretion for manager to set dealing frequency to align with the liquidity of the underlying assets (monthly, quarterly and half yearly expected in most cases).</li> <li>• Permissible to have different dealing frequencies for subscriptions and redemptions</li> </ul>
Strong investor protection measures	<ul style="list-style-type: none"> <li>• For LTAFs with lower dealing frequencies or long lock in periods, consideration of additional suitability or appropriateness requirements (similar to ELTIFs)</li> </ul>
Option to list/provide secondary trading of units	<ul style="list-style-type: none"> <li>• Option to list to provide secondary trading market for LTAFs with less frequent dealing points</li> <li>• Permissible to offer alternative facilities for secondary exchanges of units, such as matching services</li> </ul>
Liquidity Management	<p>Robust liquidity management processes to ensure that liquidity can be managed effectively and in line with the redemption terms of the LTAF in normal circumstances</p> <p>Availability of a wide tool kit to manage redemptions, including:</p> <ul style="list-style-type: none"> <li>• Notice periods</li> <li>• Deferred redemptions over more than one valuation point.</li> <li>• Suspension of redemptions only</li> <li>• Suspension of all dealing</li> <li>• Redemption gates</li> <li>• Side pockets</li> </ul>
Model based valuations	<ul style="list-style-type: none"> <li>• Pre-defined and disclosed valuation model designed for the asset classes being held.</li> <li>• Range of inputs from economic and financial information particular to the asset concerned and from the wider market (where available).</li> <li>• Use of internal or external valuers.</li> </ul>
Registration of assets	<ul style="list-style-type: none"> <li>• Allow private market investments to be registered in the name of the AIF or the AIFM acting on behalf of the AIF</li> <li>• Registration to be subject to appropriate protections to ensure assets cannot be sold or transferred without the knowledge or consent of the depositary</li> </ul>
Tax efficiency	<ul style="list-style-type: none"> <li>• The tax regime for LTAF should be designed such that it does not give rise to additional tax leakage for investors compared to their position had they invested directly.</li> </ul>

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	<ul style="list-style-type: none"><li>• Competitive VAT regime needs to be available</li><li>• Seeding relief available and ability to be seeded by a single investor for a defined period</li></ul>
Tax Incentives	<ul style="list-style-type: none"><li>• Consideration by government of tax incentives for investors in LTAFs investing a minimum percentage in projects such as UK Patient Capital or infrastructure projects over a set time period.</li><li>• ISA rules modified so LTAFs can be qualifying investment for discretionary/advised investors</li></ul>
Permitted links rules	<ul style="list-style-type: none"><li>• Permitted links rules should explicitly permit LTAFs</li></ul>



### APPENDIX 1: FAQs ON EXISTING FUND STRUCTURES



#### Are investment trusts the solution?

1. Despite the name, investment trusts are listed corporate vehicles which can themselves hold interests in private market investments. They are subject to very few investment restrictions and so a very flexible private market portfolio can be created. They also constitute a “permitted link” because the shares are listed on an exchange.
2. Investment trusts can present a satisfactory solution for some types of investors. However the downside of an investment trust is that, as an investment product, it exhibits equity-like behaviour and therefore does not provide a “true” return reflecting the characteristics of the underlying private market investments. Rather than trade at NAV, the shares will typically trade at a premium or a discount. Some investors prefer an open-ended product due to the closer correlation of the fund value with the underlying asset classes. There is also additional cost and considerable transparency around listing on an exchange which can be unappealing for managers.
3. Investment trusts are currently used by some as solutions in this market; however the feedback received by the IA from several investor groups suggests their features are not sufficiently accommodating to secure them as the most appropriate universal solution.

#### Are ELTIFs the solution?

4. The ELTIF could have been a potential solution. It provides access for retail investors to certain private market investments and constitutes a permitted link.
5. However the ELTIF portfolio composition requirements are very restrictive, and while they might work well for certain asset classes, like infrastructure, they are less easily navigated for private equity. They also do not appear to have yet been accepted by the market (platforms and intermediaries) as a sufficiently well-known vehicle amongst potential investors. Managers and intermediaries have therefore not been willing to take a risk on them. We are consequently not aware of any UK ELTIFs, to date. One of the other downsides to an ELTIF is that retail investors could have to remain invested for a considerable amount of time without any opportunity to redeem. More flexible redemption arrangements may have resulted in greater use.
6. There are some interesting features of an ELTIF. The quid pro quo for an investor’s money being locked in for a considerable length of time, is that appropriate safeguards need to be in place to ensure the investor is properly advised, the product is suitable for them and that they are limited to investing only a proportion of their overall portfolio. These represent checks and balances to counter concern that investors’ money could be locked in for a long period. We understand that the complexity of these requirements has been one of the key barriers to the development of ELTIFs.

#### What types of regulated funds are currently available for the LTAF?

7. The existing regulated structures available to managers are the OEIC, the authorised unit trust and the authorised contractual scheme (either co-ownership or

partnership). This range of structures is helpful to managers and gives them considerable flexibility.

8. Each of the above legal structures can be established as either a UCITS, a NURS or a QIS.

### **Are the COLL investment and borrowing restrictions too prohibitive?**

9. None of the three categories of authorised funds (UCITS, NURS and QIS) are truly suitable to gain access to private market investments. Although a UCITS is available to retail investors, the investment restrictions applicable to a UCITS under COLL make it unsuitable given that it is primarily restricted to investments in listed investments and other UCITS and NURS, meaning there is little scope to access private market investments.
10. Whilst a QIS has sufficient investment flexibility to allow it to access private market investments, its unsuitability for retail investors, other than sophisticated investors, means it is also unlikely to be an option for the DC market (although it may remain useful for certain types of wealth managers with professional clients).
11. The only one of the three categories of authorised funds which offers any potential solution for retail investors is the NURS. This structure can be used to engineer a portfolio that provides access to private market investments; but this is a complex and costly structuring process. Without this structuring, the current NURS' suitability is limited in a number of ways. These are explored in the main report.
12. As highlighted in the above, although a NURS offers the only potential option of the three types of authorised funds available, there is still currently a need to do some complex structuring to create a private market investments portfolio that works within the COLL restrictions. This structuring results in additional costs and decreased transparency for investors. Any portfolio constructed must also have regard to the liquidity management requirements. As such, creating a more flexible investment and borrowing power regime only works if more flexibility is introduced in liquidity management options; as the two go hand in hand.
13. Recommendations – we believe the key areas for increasing flexibility in terms of investment and borrowing powers are relaxing the restrictions on investments in limited partnerships, restrictions on the second scheme, the use of the unlisted securities limit and the borrowing/guarantee provisions.

### **Are the COLL liquidity management restrictions too prohibitive?**

14. Pursuant to COLL, all authorised funds are currently required to have a valuation point at least every fortnight. This means that managers need to ensure sufficient liquidity within their portfolio to be able to meet redemption requests, at a minimum, every fortnight. This position is not compatible with the nature of private market investments which can take a long time, and can be costly, to sell. This means that even if a manager has constructed a portfolio with a considerable private market exposure employing some of the techniques referred to above, they still need to ensure sufficient liquidity to meet redemption requests.
15. The only ways of achieving this are:

- Retaining a large part of the portfolio in liquid investments (this is possible but is going to drag performance and mean that the manager is not being paid to manage a complete portfolio of private market investments);
  - Using borrowing to bridge redemption requests (as discussed above, this is challenging within the confines of the current rules);
  - Employing liquidity management tools (discussed below); and
  - Trying to avoid the reputational consequences of a full suspension. We note the FCA discussed suspension in CP18/27, however managers are unlikely to want to rely on suspension, not least due to the negative impact portrayed in the media on the use of suspension.
16. A NURS operating as a FAIF can include limited redemption mechanisms which can, in theory, be applied either in extraordinary market circumstances, or on a permanent basis. When applied the impact is that a fortnightly valuation point is not required and valuation points can be up to six months apart. COLL also provides that a NURS operating as a FAIF which permits limited redemptions must pay redemption proceeds within 185 days of the date of receipt and acceptance of the instruction to redeem. In the context of private market investments six months may not be enough time to liquidate assets. COLL is however unclear and does not provide any guidance on when a redemption is deemed to be received or accepted so it could be argued that this 185 day period does not start to run until the end of a limited redemption period (which can last up to six months) if one was in operation at the time an investor requests to redeem. This in theory means that a manager could utilise a limited redemption period to limit redemptions for well in excess of the six month period.
17. A NURS operating as a FAIF can also defer redemptions. Unhelpfully, there is no clarity in COLL on how long you can defer for. Again, COLL requires that redemption proceeds should be paid to investors within 185 days of the date of receipt and acceptance of the instruction to redeem. It is arguable that the acceptance of the instruction to redeem does not occur until the gate is lifted. This means in theory a NURS could end up with deferred redemptions for significant periods of time much longer than six months, however the FCA appears uncomfortable with using the tools in such a way as to look like a "soft suspension". There is also the possibility that it is not only redemption requests, but also AUM decline, which can trigger gating. The FCA does not seem comfortable with this possibility.
18. Another issue associated with liquidity is dilution. If a manager sells a portion of the NURS' liquid portfolio to meet redemption requests, this leaves remaining investors with the "rump" of illiquid assets which not only take longer to sell, but will potentially be more costly to sell. This means that managers may need to employ dilution techniques. Our experience shows that most platforms cannot accommodate a dilution levy and so dilution adjustment is the only way to mitigate the impact of dilution. The swing could be quite significant in the context of private market investments.
19. The ability to impose redemption charges may be a useful tool for managers in the context of liquidity management. Whilst managers may not want to impose a redemption charge in ordinary market circumstances, they may welcome the flexibility to be able to impose one in extraordinary circumstances in which they



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consider it is not possible to value the assets accurately. Alternatively, it could be a tool to encourage the giving of a specific period of notice of redemptions i.e. if an investor provides a certain amount of notice of a redemption request, no redemption fee would be applied; however if they wished to redeem without having provided such notice, a redemption fee would be applied.



## ANNEX 2: ONSHORE ALTERNATIVES / PROFESSIONAL REGIME SUB-GROUP REPORT



### CHAIR'S FOREWORD

The UK is a strong and attractive jurisdiction for investment from both UK professional investors and those from abroad. UK Financial Services law and regulation is world-renowned and the FCA's reputation abroad is as an efficient and effective regulator. There is considerable expertise in fund management in the UK, which is an attraction for many.

Despite the attractiveness of the UK, there is an unfortunate perception that there are no suitable fund vehicles outside mainstream investments for the retail fund market and traditional pooling vehicles for UK institutional investors. There is also a perception that regulatory and tax barriers make investment in the UK less attractive than abroad.

Jurisdictions offshore have established fund structures for professional investors with a less stringent regulatory burden than that in the UK authorised fund regime and those structures have attracted significant investment from both the UK and internationally. Investment in UK funds has traditionally come from UK institutional investors.

The UKFRWG has analysed the case for a new type of fund regime for professional investors from both the UK and abroad. An exploration of successful fund domiciles has demonstrated that there is strong demand for unauthorised professional structures. The new regime would be a welcome growth opportunity for the UK and would be a strong tool to promote the UK's competitiveness in the unauthorised fund market.

The UKFRWG has therefore developed proposals for an alternative unauthorised corporate fund vehicle and unauthorised partnership structure. These funds would have a wide remit as regards investment powers, enabling them to adopt alternative and innovative investment strategies.

As part of these proposals, the UKFRWG recommends that the new vehicles are tax-neutral and that HMRC overhauls the current VAT regime, to assist the success of the new structure when competing with the already successful fund regimes overseas.

The UKFRWG also supports the proposals from the Alternative Investment Management Association on developing an alternative unauthorised corporate fund vehicle.

We look forward to working with HM Treasury to develop the UK professional funds regime to ensure that the UK remains competitive in the global market.

**Julie Patterson, Chair, Onshore Professional Fund Working Group**

### INTRODUCTION

1. The Onshore Alternatives Group (OAWG) is a sub-group of the UK Funds Regime Working Group (UKFRWG).
2. The objective of the OAWG is to identify what changes, if any, are needed to maximise the relevance and usability of UK investment funds for professional investors.
3. Membership of the group draws on a wide range of experience across different parts of the market, including alternative investment fund managers.
4. Input was gathered from the OAWG membership through group meetings and one-to-one discussions with a range of stakeholders. We have also sought to coordinate closely with other initiatives looking at similar areas covered in the Report.

### UK INVESTMENT FUNDS AND PROFESSIONAL INVESTORS

5. This report advocates for the introduction of a new type of UK investment fund for professional investors - a UK **"Onshore Alternative Fund"**. A UK Onshore Alternative Fund would be directed towards professional investors both in the UK and, crucially, global professional investors. In our view, the introduction of a UK Onshore Alternative Fund would greatly assist in promoting the UK's competitiveness in the alternative funds space and would provide the UK with a unique growth opportunity.
6. At present, there is a disconnect with the UK's reputation for incubating and facilitating the growth of an ecosystem in which we are global leaders in fund management and the ongoing perception that the UK is seen as a not as a welcoming environment for fund establishment in the alternatives sector as other jurisdictions, such as the Cayman Islands, Ireland and Luxembourg. Key perceived barriers to entry, include a view that the UK does not have a fund vehicle which is tax-efficient or is otherwise encumbered and that, in general, the UK is not minded to encourage business in the fund establishment arena.
7. In fact, UK funds invested in listed securities have access to the UK's extensive double tax treaty network and are in certain circumstances more tax-efficient than funds in certain successful domiciles. This underlines the need for the UK more actively to promote both its current fund regimes and any possible future fund vehicles, to counteract the misinformed reputation of the UK as unattractive from a regulatory and tax perspective. Significantly, the UK already has a deep history of attracting world-leading portfolio management expertise, nurturing a fund custodian and depositary industry that is well-established and well-regarded, establishing fund administration centres throughout the country, and generating and attracting top-class professional services firms and individuals which are seen as thought leaders advising financial services regulation globally. Given these factors, we believe there is a strong case for more flexible professional fund vehicles to enable the UK to compete for global opportunities.
8. Brexit has focussed minds on UK competitiveness, but irrespective of Brexit, evidence from other successful fund domiciles points to strong investor demand for unauthorised fund structures that facilitate investment in alternative asset classes and investment strategies in a tax-efficient manner. Such professional investor



demand is not just from the UK or the EU, but also from jurisdictions as the US, Latin American countries, Asia-Pacific countries and Africa. The UK has a strong track record of openness toward international business. Indeed, Forbes in 2019 rated the UK the best country for business, from a list of 161 countries and the Globalization and World Rankings Research Institute has rated London as one of only two Alpha++ cities, the other being New York. **For us, this signifies that, if pursued in a thoughtful and active manner, the creation of a new UK Onshore Alternative Fund would be a strong indicator to global markets that the UK wishes to continue its long-standing history as a key jurisdiction for fund management in all areas, including the alternatives sector.**

9. The sub-group also recommends that the UKFRWG supports AIMA's proposal for a new, unauthorised corporate fund vehicle and proposes that an unauthorised partnership structure also be introduced. The current QIS structure should be improved to make it attractive to a wider range of investors, but it will not alone enable the UK to become a fund domicile of choice. The tax regimes for all three types of funds should be reviewed to ensure that they are as attractive to investors as offshore funds.

### PROPOSALS FOR A UK ONSHORE ALTERNATIVE FUND

10. A new type (or types) of UK Onshore Alternative investment Fund(s) should not be constrained as regards asset classes or investment strategies, or whether it is open or closed-ended, or listed or unlisted. Consequently, there should be multiple options created to allow for an unauthorised fund that is available to professional investors/semi-professional (e.g. wealth managers) investors. This should also include the option to establish an unauthorised partnership structure as well as the development of a corporate alternative funds vehicle. Such funds would be:
  - A registered AIF (however, this is to be distinguished from a requirement to be authorised/ regulated with regards to investments such a fund may make).
  - Managed by an authorised UK AIFM.
  - Overseen by an authorised UK depositary.
11. We note that the FCA has sufficient and knowledgeable resource already available to regulate the managers of such alternative funds (in fact, it is a world leader in regulating fund managers). However, we recognise additional expertise may be required in understanding the nuances of having an additional volume and different categories of offshore alternative funds. In which case, having staff who have experience in offshore professional funds would be an advantage.
12. In fact if such proposals were pursued, there would be a competitive need for the UK to ensure that authorisation of the managers of such funds or registration of an Onshore Alternative Fund is not overly time-consuming or costly.
13. We note that the Alternative Investment Management Association ("AIMA") has also been working with HMT and HMRC to develop an alternative fund vehicle for

professional investors. In the light of Brexit, AIMA identified the need to review the UK fund regime as both a business opportunity and as a defensive measure. The sub-group has been in dialogue with AIMA and understands that AIMA is proposing, as a first step, a new unauthorised corporate fund structure, which will require amendments to secondary legislation and tax law. **The sub-group recommends to the UKFRWG that it supports AIMA's proposal.** While considering the tax treatment for such a fund, the shape and coherence of the tax regime of all UK fund vehicles should be considered through a full consultation process with the industry from the outset.

14. It is clear from successful fund domiciles in Europe and globally that both alternative unauthorised corporate fund vehicle and unauthorised partnership structures need to be available for investors, especially in alternative asset classes and investment strategies. **The sub-group therefore proposes that such vehicles be created in the UK, which will require amendments to partnership law, as well as to secondary legislation and tax law.**
15. The UK tax regime for any new professional fund vehicles needs to ensure that the fund is tax-neutral. In addition, a competitive VAT regime for management of such fund vehicles would be critical for their success as a suitable alternative to currently available funds outside the UK. Under the current VAT regime, a UK investment manager managing an offshore fund can benefit from full VAT recovery while no VAT is charged to the fund itself. In contrast, the management of UK funds is either exempt from VAT (if they are qualifying funds), or is subject to VAT (otherwise). Most alternative investment funds are not regarded as qualifying funds and hence suffer VAT. Where the fund is exempt from VAT, the input tax recovery of the investment manager is restricted. For a UK onshore alternative fund structure to be commercially viable, **the current VAT treatment available on UK management of offshore funds needs to be extended to management of any such new UK vehicles. This can be done, for example, by applying a zero rate of UK VAT to the management of such funds.** We note, however, that under current EU VAT law it would not be possible for such zero-rating provisions to be introduced in the UK
16. It is important to ensure that there is an appetite in the market to act as depositary for such funds. Reduced choice of options for depositaries of such funds would not be conducive to promoting effective competition and may drive up costs for the funds, and ultimately the investors.

### CURRENT UK POSITION

17. The UK is an attractive jurisdiction for international investors, as can be observed by the amount of securities listed on UK exchanges. The UK Listing Regime, Takeover rules and financial reporting requirements, and their effective enforcement, are world-renowned. UK financial services regulation is a world-leader, and the FCA is viewed overseas as being an efficient and effective regulator.
18. The UK has historically attracted talent in the investment management industry. Investment managers in the UK are seen as the "gold standard". The UK depositary industry is similarly well-developed and well-regarded, with experience in all types of

asset classes. It has access to global custodian networks, allowing investment by funds in almost any jurisdiction in the world. The UK's time zone is well placed for international business, particularly from Asia-Pacific, Africa and the Middle East.



19. The fund management industry in the UK is also well-established, with administration centres located throughout the country. There is a wealth of top-class knowledge and experience in UK professional services firms.
20. Given its many attractions, there is large untapped appetite from UK, EU and international investors to invest in or through the UK, but the perception of the UK fund regime is that there is no suitable vehicle for meaningful investment in alternative products, and that regulatory and tax barriers make the UK unattractive. UK funds attract strong investment from all types of UK investors, but investment from the global market has traditionally gone offshore.
21. The UK has, for many decades, offered unauthorised unit trusts for professional investors, but only the exempt version is used to any notable degree and only by UK pension funds and charities. The prolonged absence in the UK of appropriate alternative vehicles enabled other jurisdictions to establish themselves as leading, innovative jurisdictions for fund domicile and administration.
22. The UK Qualified Investor Scheme (QIS) was intended to be an attractive export vehicle, but the initial requirements were too restrictive and deterred both managers and investors. The Authorised Contractual Scheme (ACS) has improved the attractiveness of the QIS but only for certain types of UK investors. Other jurisdictions therefore remain dominant as fund domiciles.

**Table 1: Fund Sizes and Number of Fund Managers in Key Jurisdictions**

	<b>Cayman Islands</b>	<b>Ireland</b>	<b>Luxembourg</b>	<b>UK</b>
<b>Fund Size (£m)</b>	10,916*	840,575	1,530,785	1,244,731
<b>Number of fund managers</b>	85	374	268	128

\* Number of mutual funds as at 31 March 2019. Value not available.

23. Post-Brexit (or post any transition period), the UK will lose the AIFMD managing and marketing passports. For European investors, the marketing passport allows them access to UK AIFs, but its loss may not be significant for the UK. Recent research for the European Commission found that the AIFMD has not impacted European investors' appetite for non-EEA funds. They continue to access such funds via national private placement regimes or "reverse solicitation". What the UK lacks is an appropriate fund structure.

### COMPETITOR FUND DOMICILES



24. Certain jurisdictions, such as the Cayman Islands, Bermuda and Delaware have, for a long time, offered unregulated fund structures that offer investors the opportunity to access alternative assets and investment strategies with relatively few constraints. These fund structures have traditionally been attractive to institutional and professional investors, due to their wide investment powers, innovative investment strategies and attractive tax features. However ongoing media scrutiny and public perception has increased the attention on tax havens and consequently such structures are slowly becoming less popular with investors, particularly in the EU. Recent EU-domiciled fund alternatives to the traditional offshore arrangements have been relatively successful.
25. The Irish Qualified Investment Fund (QIF) and the Luxembourg Specialised Investment Fund (SIF) were introduced in the mid-00s, followed by the UK QIS in 2004. Both the QIF and the SIF had some success but the UK QIS was rejected at the outset by the industry and investors due to a 10% investor limit. This condition was significantly modified some time later, but QIS (being OEICs or authorised unit trusts) did not attract much interest until the introduction of the ACS. Even so, they remain of interest only to UK institutions – mainly pension funds (see below).
26. Implementation of the Alternative Investment Fund Managers Directive (AIFMD) in 2013, which requires the AIF manager (AIFM) to be authorised but not the AIF, caused key European fund domiciles to review their regimes and to introduce unauthorised AIFs for professional investors, most notably the Reserved Alternative Fund ("RAIF") in Luxembourg and the Qualifying Investor Alternative Investment Fund ("QIAIF") in Ireland. The QIAIF was designed with the specific aim of securing benefits of the Ireland/US double tax treaty.
27. Appendices 1 and 2 provide summary comparisons of QIS and EUUTs with regulated and unregulated professional funds in some key fund domiciles.

### ENHANCEMENT OF EXISTING UK FUND REGIME

28. The current UK fund regime does not provide an adequate fund structure for investing in alternative assets or investment strategies, especially not for non-UK professional investors. The main features of the principal UK fund structures available to professional investors are summarised below.
29. Each of the existing fund structures has its place in the UK professional market, but is of limited attraction. The rules for QIS merit some improvements, but this alone would not produce a sufficiently attractive vehicle for non-UK (and for some UK) investors.

### UNAUTHORISED UNIT TRUSTS

30. The unit trust regime in the UK is well-established and unauthorised unit trusts (UUTs) have been used for many years for certain types of UK investors.

31. In particular, exempt unauthorised unit trusts (EUUTs), which benefit from a number of tax exemptions (such as stamp duty), are used by UK pension funds and charities. Such investors have found that these vehicles are suitable for their purposes, but these funds do not serve other UK and overseas investors as well.
32. The unit trust structure is not a well-understood concept outside the UK, so unit trusts are difficult to export internationally. The UUT's main disadvantage is the inability to pool assets for different types of investor given that non-exempt UUTs are generally tax-inefficient.
33. Even within the UK, UUTs are viewed as an old-fashioned structure. They are not seen as sophisticated with regards to investment strategy and objectives, and also attract VAT which puts them at a significant disadvantage compared to offshore alternatives. Additionally they are also opaque for tax purposes which means that their tax transparency is generally inferior to transparent options. Hence they fail to attract other types of professional investors.
34. **The sub-group believes that UUTs/EUUTs serve a purpose for those currently investing in them and should be allowed to continue (at least until such time that a new, more attractive regime is in place), but UUTs/EUUTs are not able to be developed to attract investment from overseas investors or a wider range of UK professional investors.**

### INVESTMENT TRUSTS

35. Listing in the UK carries some prestige and UK listing can be attractive to investors. Investment in a listed fund in general provides liquidity, but liquidity is not necessarily of prime concern to professional investors, who are more likely to sacrifice liquidity of a fund for a diverse or complex strategy and performance.
36. Listed funds are not authorised by the FCA, and therefore do not need to comply with FCA regulation, in particular the rules in COLL, but they do have to comply with the Listing Rules, which can be onerous and expensive.
37. Investment trusts are companies and therefore, subject to specific provisions to the contrary, all corporate tax legislation applies to them. In order to be approved as an investment trust, a company has to meet specified conditions including distribution of at least 85% of its income each year. The regime includes various restrictions as regards investment and borrowing powers.
38. There are specific provisions for listed investment companies that take the form of venture capital trusts (VCTs) and real estate investment trusts (REITs), both of which benefit from specific exemptions and provisions under UK tax legislation.
39. **The UK's listed closed-ended funds framework is long-established and attracts investments from the UK and overseas. These vehicles have a place for professional investors. The sub-group does not make any recommendations as regards changes to the listing or tax rules applicable to them.**

## QUALIFIED INVESTOR SCHEMES



40. The QIS was launched in the UK in 2004. The regulations are flexible as regards legal structure, permitting unit trusts, open-ended investment companies (OEICs or ICVCs), authorised contractual scheme (ACS - see below) and partnerships. Currently, there are 33 QISs, with a total of 72 sub-funds.<sup>21</sup>

**Table 2: Number of Authorised Qualified Investor Schemes, by Scheme Type**

	<b>Single funds</b>	<b>Umbrella funds</b>	<b>Sub-funds</b>
<b>ACS</b>	1	9	48
<b>AUT</b>	4	5	17
<b>ICVC</b>	9	5	7

41. The investor base is European (largely UK) and largely pension and insurance funds. QISs need to be of a large enough size to attract these investors, who want a low-cost investment option. The experience of QIS managers is that many investors in offshore funds such as Cayman Island funds are less concerned with costs, but are not investing in QISs.
42. QIS managers also reported that wealth managers are not interested in investing in QISs for their underlying investors, and that QIS managers do not market QIS to individuals. The QIS is not available to retail investors that are semi-professional, so such investors have restricted access onshore to private equity and the higher cap (100%) on borrowing.
43. The QIS is more flexible than retail authorised funds in relation to permitted investments. Also, the QIS is not subject to diversification limits, other than a restriction on investment in unregulated collective investment schemes, unless the manager has undertaken appropriate due diligence on those schemes. However, the QIS investment and borrowing powers could be more flexible. There should be a review permitted investments (including a review of the Regulatory Activities Order) and of the level of the cap on leverage.
44. The FCA is required to process QIS authorisation applications within six months of receipt, although it aims to process applications within one month. In comparison, the Central Bank of Ireland operates a "Fast Track" authorisation process for QIFs and QIAIFs. Provided all parties have previously been authorised by the Central Bank, the fund's Board and legal advisers can certify the documents and file with the Central Bank, which will authorise the fund the following day without review of the documents. The Luxembourg regulator, too, has a fast track authorisation process for professional funds.
45. QIS managers interviewed confirmed that the FCA authorisation process had been relatively simple, although robust. However, there was some comment regarding the regulation of such funds. The FCA appears to view the management of QISs the

<sup>21</sup> Source: FCA website, May 2019

same way that they do for retail funds. This has resulted in some (and in the view of interviewees, unnecessary) comments in relation to e.g. the language used in the investment objective/policy. Also, the rules around investor relations are identical to those for other funds so, e.g. an introduction of a new type of fee would require an EGM, which is not the case for Cayman funds.

46. QISs must distribute all income to investors or provide accumulation share classes in which income distributions are re-invested. Investors are subject to tax on distributions received or re-invested. It has been noted that the majority of the intended investor base (professional investors) are less concerned about receiving income, and funds should be given the option not to distribute. Similar regimes, such as the Irish QIF do not have a requirement to distribute income. Also, QISs cannot accommodate carried interest and are not generally permitted to distribute capital gains.
47. The introduction of the ACS (see below) has led to increased interest in the QIS, but it is still at a much lower level compared with fund structures on competitor fund domiciles. **The sub-group is of the opinion that the QIS rules require some improvement in order to improve their attractiveness to UK professional investors. Features available in other jurisdictions should be considered. However, improvements to the QIS will not alone attract sufficient interest from non-UK investors.**

### AUTHORISED CONTRACTUAL SCHEMES

48. The Authorised Contractual Schemes (ACS) is the third legal form of authorised open-ended investment fund, alongside the Authorised Unit Trust (AUT) and the OEIC. The ACS was introduced in the UK in 2014 and can take the form of either a partnership or a co-ownership scheme.
49. ACS offer investors the benefits of collective investment alongside tax transparency, i.e. the ability to preserve the tax status of the investor in relation to the investments made by the fund. This is attractive to many investors including, for example, pension funds that can retain the benefits that are afforded to them by tax treaties and by many tax regimes throughout the world. However, it requires additional administrative procedures and personalised reporting. Moreover, the ACS is not yet recognised in all key double tax treaties. Tax reporting obligations and complexities arising from transparency make the ACS unsuitable as a vehicle for taxable investors as well as for a large number of investors.
50. To date, the ACS has been used mostly for UK pension funds and charities. Other investors have perceived the ACS as expensive to administer, so it has not gained significant traction, in contrast to take-up of the Luxembourg RAIF, for example (see below).
51. **The sub-group believes that with some development, the ACS QIS could be a suitable vehicle for an onshore alternatives fund for a wider range of UK professional investors and possibly for some non-UK investors. However, it believes that the ACS QIS would be unlikely to become a vehicle of**



**choice for the numbers of non-UK investors that the UK needs to attract in order to be a world-class fund domicile.**



### PARTNERSHIPS

52. Partnerships are a popular fund vehicle outside the UK, e.g. in Luxembourg for venture capital and private equity investment.
53. Scottish partnerships are preferable to English/Welsh vehicles as they involve less legal administration, e.g. English partnerships are required to list partners at Companies House. Also, Scottish partnerships are “persons in law”, so count as one investor, not many. This is of particular benefit in countries such as the US that limit the number of investors in a fund to secure certain treatment under national regulation.
54. The Limited Partnership Act 1907 (as amended) makes a small number of provisions affecting how the Partnership Act 1890 applies to limited partnerships. The 1890 Act itself leaves in effect the common law relating to partnerships save where that is inconsistent with it. The law is also intended primarily for commercial partnerships. Therefore, there is not a dedicated code for investment partnerships which reflects the differences between an investment fund and a commercial business.
55. **The sub-group believes that an attractive, unauthorised partnership regime is essential in order for the UK to be a competitive and world class fund domicile. This would require substantial amendments to partnership law (as well as to secondary legislation and tax law) to create a distinction between investment partnerships and ordinary commercial partnerships.**

### TAX REGIME

56. The tax regime for any new professional fund vehicles needs to ensure that the fund and any other UK holding entities are tax-neutral and where possible, offers access to the UK’s vast network of double tax treaties.
57. In addition, **a competitive VAT regime for management of such fund vehicles would be critical for their success as an efficient alternative to currently available competitor offshore funds.** Under the current VAT regime, a UK investment manager managing an offshore fund can benefit from full VAT recovery while no VAT is charged to the fund itself. In contrast, the management of UK funds is either exempt from VAT (if they are qualifying funds), or is subject to VAT (otherwise). Most alternative investment funds are not regarded as qualifying funds and hence suffer VAT. Where the fund is exempt from VAT, the input tax recovery of the investment manager is restricted. For a UK onshore alternative fund structure to be commercially viable, the current VAT treatment available on UK management of offshore funds needs to be extended to management of any such new UK vehicles. This can be done, for example, by applying a zero rate of UK VAT to the management of such funds. We note, however, that under current EU VAT law it would not be possible for such zero-rating provisions to be introduced in the UK.



58. Attractiveness for both UK and foreign investors must be considered. For instance, the tax regime for UK resident non-domiciled investors makes it expensive for them to invest in the UK.
59. **While considering the tax treatment for such funds, the shape and coherence of the tax regime of all UK fund vehicles should be considered through a full consultation process with the industry from the outset.**

## CONCLUSION AND RECOMMENDATIONS

60. The UK offers many benefits for investors, including world-leading portfolio management expertise, a fund depositary industry that is well-established and well-regarded, fund administration centres throughout the country, top-class professional services firms and world-leading financial services regulation. It is not, however, a top fund domicile. As the UK moves closer towards its exit from the EU, now is a good time to review existing UK fund structures and improve the UK's attractiveness as a fund domicile to investors worldwide.
61. Evidence from successful European and global fund domiciles points to strong investor demand for unauthorised fund structures that facilitate investment in alternative asset classes and investment strategies in a tax-efficient manner. The sub-group is of the opinion that there would be a demand for a UK-domiciled alternatives fund, aimed towards professional investors in the UK, EU and worldwide. Semi-professional investors should also be accommodated.
62. The sub-group recommends that the UKFRWG supports AIMA's proposal for a new, unauthorised corporate fund vehicle and proposes that in addition an unauthorised partnership structure also be introduced. The current QIS structure should be improved to make it attractive to a wider range of investors, but it will not alone enable the UK to become a fund domicile of choice.
63. The shape and the coherence of the UK tax treatment of existing as well as any UK fund vehicles should be reviewed to enhance the attractiveness of the UK as a location for fund domicile. The review could involve various alternatives such as simplifying the existing special tax regime for UK funds or introducing a new fund tax regime with the option to convert existing funds to the new regime, with the ambition that such a fund would have no tax filing requirements.
64. The current VAT treatment of UK AIFs compares poorly to the VAT treatment of offshore alternatives and hence will need to be reviewed to ensure that VAT treatment of onshore alternatives looks to put them on an equivalent footing to offshore alternatives. This can be done, for example, by applying a zero rate of UK VAT to the management of such funds. We note, however, that under current EU VAT law it would not be possible for such zero-rating provisions to be introduced in the UK.
65. Any review of the fund tax regime must be carried out through a full industry consultation from the outset as any changes are likely to have a significant impact.

## APPENDIX 1: COMPARISON OF UK AND OFFSHORE FUND STRUCTURES – AUTHORISED FUNDS

	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
<b>Jurisdiction</b>	United Kingdom	Luxembourg	Ireland
<b>Legal Structure</b>	Can be a unit trust, ICVC, ACS or partnership	Civil Code System Can use any legal structure available in Luxembourg	Can be structured as an investment company, unit trust, Common Contractual Fund (CCF) or investment limited partnership (ILP).
<b>Regulatory Authority</b>	Financial Conduct Authority (FCA)	Commission de Surveillance du Secteur Financier (CSSF)	Central Bank of Ireland (CBI).
<b>Basic Structure</b>	<p>A unit trust needs to be constituted by a Trust Deed, entered into by the Manager and the Trustee.</p> <p>ICVCs are incorporated as a company under an Instrument of Incorporation. The Manager must appoint a depositary.</p> <p>Units/shares are issued to investors, representing a proportion of the net assets of the fund. Shareholder liability is limited to the shareholding.</p> <p>Units/shares can be issued in different classes with different management fees, investment level and charges and different lock-up periods / liquidity terms.</p> <p>An ACS has no legal personality and investors are co-owners of the pool</p>	<p>Corporate vehicles need to be formed before a notary public and usually issue shares to investors, representing a proportion of the net assets of the fund. Shareholder liability is limited to the shareholding.</p> <p>Shares can be issued in different classes with different management fees, investment level and charges and different lock-up periods / liquidity terms.</p> <p>Corporate vehicles (with the exception of the corporate partnership limited by shares, or SCA) will not have a general partner.</p> <p>For SIFs formed as partnerships, two types of limited partnerships are available in Luxembourg: the société en commandite simple (SCS) and the société en commandite spéciale (SCSp). The only difference between the two types of</p>	<p>An investment company is incorporated and investors hold shares in the company.</p> <p>A unit trust is constituted by a Trust Deed, entered into by the Manager and the Trustee.</p> <p>Units/shares are issued to investors, representing a proportion of the net assets of the fund. Shareholder liability is limited to the shareholding.</p> <p>A CCF is an unincorporated body established under a deed where investors are “co-owners” of underlying assets.</p> <p>The ILP is a regulated partnership structure, constituted by a Limited Partnership Agreement (LPA). General Partners are liable for the debts of the ILP where assets are</p>

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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
	<p>of assets. The ACS is formed under a Co-Ownership or Partnership Deed.</p> <p>Partnerships are formed between partners under a Partnership Agreement. Investors in the fund are partners, with rights dependent on the extent of their investment.</p>	<p>partnership is that the former has legal personality while the latter does not.</p> <p>These limited partnerships are formed between one or more general partners and at least one limited partner through execution of the limited partnership agreement (before a notary public or under private seal) and the contribution to the partnership.</p> <p>Investors can hold capital accounts or interests in the partnership and the interests may be issued as securities (titres).</p> <p>The general partner is liable (beyond the limited partnership's assets) for the debts and obligations of the limited partnership and limited partners' liability is limited to the extent of their capital contributions.</p>	<p>insufficient to cover. Limited Partners have limited liability. Assets and liabilities belong jointly to the partners in the proportions agreed in the LPA.</p>
<b>Legal Personality</b>	Yes for OEIC. No for unit trust, ACS or partnership	<p>Yes for corporate vehicles and the SCS partnership. Corporate vehicles can own assets, enter into contracts, sue and be sued, own property, borrow money and grant certain types of security. The AIFM/Investment Manager can also contract on its behalf through delegation of this power by the relevant board.</p> <p>No for SCSp partnership.</p>	Yes for investment company. No for unit trusts, ILPs and CCFs.
<b>Ownership of Assets</b>	For unit trusts, held in trust for the investors, by the Trustee, who has	Corporate vehicles: assets are owned by the fund vehicle or subsidiaries.	For investment companies, the assets are the property of the company.

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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
	<p>legal ownership of the scheme property.</p> <p>For ICVCs, assets owned by the fund, with investors having a beneficial interest through their shareholding.</p> <p>For ACSs, investors are the co-owners of the assets.</p>	<p>Partnerships – determined in partnership agreement.</p> <p>Assets are generally held by the Depositary, or ownership must be verifiable.</p>	<p>For unit trusts, the Trustee is the legal owner, on behalf of investors.</p> <p>Investors are co-owners of the assets held by a CCF.</p> <p>The partners co-own the assets of an ILP, in the proportions agreed in the LPA.</p>
<b>Regulatory Status</b>	<p>As a regulated vehicle, the QIS must be approved by the FCA prior to launch. The authorisation will be granted subject to approval of:</p> <ul style="list-style-type: none"> <li>the constitutional documents;</li> <li>the choice of directors/managers;</li> <li>the depositary bank and auditor;</li> <li>the persons or entities in charge of the investment management function;</li> <li>the administrative agent.</li> </ul> <p>An offering document and three year business plan must be produced and approved by the FCA.</p>	<p>As a regulated vehicle, the SIF must be approved by the CSSF prior to launch. The authorisation will be granted subject to approval of:</p> <ul style="list-style-type: none"> <li>the constitutional documents;</li> <li>the choice of directors/managers;</li> <li>the depositary bank and auditor;</li> <li>the persons or entities in charge of the investment management function;</li> <li>the administrative agent.</li> </ul> <p>An offering document must be produced and approved by the CSSF.</p>	<p>As a regulated vehicle, a QIF must be approved by the CBI prior to launch, providing the following are in place and pre-approved:</p> <ul style="list-style-type: none"> <li>Promoter</li> <li>Investment manager</li> <li>Directors</li> <li>Trustee/Depositary</li> <li>Administrator</li> </ul>
<b>Diversification Requirement</b>	<p>No diversification limits on permitted investment and short positions.</p> <p>Investment in unregulated schemes restricted to 20% unless the</p>	<p>SIFs may not invest more than 30% of their assets in assets of the same type issued by the same issuer. Look-through is allowed, as is ramp up period.</p>	<p>Investment companies must confirm the aim of spreading risk as required by Irish company law.</p>

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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
	<p>manager carries out appropriate due diligence on the unregulated scheme.</p> <p>Investment in second schemes only permitted where the second scheme does not invest more than 15% of its assets in other schemes.</p>		Maximum of 50% of NAV in any one scheme to avoid qualification as a feeder fund.
<b>Regulatory Wrappers and Marketing Passports</b>	<p>QISs are subject to regulatory supervision by the FCA.</p> <p>QISs will be capable of being marketed to investors meeting the definition of “qualified investor” under the private placement rules.</p>	<p>SIFs are subject to regulatory supervision by the CSSF. SIFs may be marketed (in addition to passport marketing if AIFMD applies), to “well-informed investors” in accordance with applicable private placement rules.</p> <p>If AIFMD applies, the manager will need to be regulated. Provided that this is the case (and if the manager is subject to full-scope regulation under AIFMD) the SIF is fully capable of passporting under the AIFMD passport for marketing purposes throughout the EEA, save where it is a feeder fund to a non-EEA AIF.</p>	<p>QIFs are subject to regulatory supervision by the CBI.</p> <p>If AIFMD applies, the manager will need to be regulated. Provided that this is the case (and if the manager is subject to full-scope regulation under AIFMD) the QIF is fully capable of passporting under the AIFMD passport for marketing purposes throughout the EEA.</p>
<b>Umbrella/Series Structure and Segregated Liability</b>	<p>OEICs can be structured as an umbrella, with an unlimited number of sub-funds.</p> <p>Umbrellas have segregated liability between sub-funds.</p>	<p>Yes. An umbrella structure can be created in which multiple sub-funds are possible. The SIF will enter into service provider agreements at the umbrella level (portfolio managers may be appointed to specific sub-funds), but assets and liabilities belong to the individual funds.</p> <p>Umbrella SIFs have segregated liability between sub-funds pursuant to the SIF Law.</p>	Umbrella structures can be established for QIFs with segregated liability between sub-funds.

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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
<b>Management</b>	<p>Unit trusts are managed day-to-day by the Authorised Fund Manager (AFM).</p> <p>ICVCs are managed by the Authorised Corporate Director, who may be the sole director of the fund.</p> <p>A Manager is appointed to perform the day-to-day management of an ACS.</p> <p>Investment management may be sub-delegated to a third party, but the manager/AFM/ACD retains ultimate responsibility for the management of the scheme.</p>	<p>Corporate vehicles: day to day management of the SIF is conducted by a board of directors (in SCA form, board is at the level of the general partner).</p> <p>Corporate vehicles may be managed by an external AIFM/management company or may be a self-managed entity (i.e. the corporate vehicle is, itself, an AIFM). The AIFM can either do the investment management in-house or appoint a delegate portfolio manager.</p> <p>A limited partnership must be managed by at least one general partner. The limited partner can be the AIFM under AIFMD or can appoint an AIFM. The AIFM can either do the investment management in-house or appoint a delegate portfolio manager.</p>	<p>Investment companies provide the day-to-management of the fund, if self-managed, or may appoint a management company.</p> <p>Unit trusts and CCFs must appoint an Irish-domiciled management company.</p> <p>The ILP is managed by one or more General Partners.</p>
<b>Directorship Requirements</b>	<p>ICVCs are required to have at least one director. In practice, this is the Authorised Corporate Director, generally a UK-incorporated, FCA-regulated entity.</p> <p>Independent directors are possible.</p>	<p>SIFs must appoint at least three directors. There is no residency requirement though, in practice, at least some of the directors tend to be resident in Luxembourg.</p> <p>A set of documents (including CV, police clearance and table with time commitments) need to be filed with the CSSF as part of the SIF application process.</p> <p>The CSSF approves the directors as part of the SIF approval process.</p>	<p>Investment companies must have a Board of Directors, at least 2 of whom must be Irish resident.</p>

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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
		<p>The general partner of a non-SIF, non-RAIF, limited partnership can have a single director. There is no legal requirement to have Luxembourg resident board members.</p> <p>Where the SIF is a limited partnership, at least three directors are required.</p>	
<b>Tax Transparency</b>	Yes for ACS; otherwise no.	<p>No for corporate vehicles and the SCS partnership.</p> <p>Yes for SCSp partnership.</p>	<p>Yes for CCF and LP</p> <p>No for unit trusts.</p>
<b>Tax treatment</b>	<p>Dependent on the legal form of the QIS.</p> <p>OEICs and unit trusts are taxed in the same way.</p> <p>Subject to corporation tax of 20% on taxable income. No tax on dividends.</p> <p>Exempt from CGT on gains made on buying and selling of underlying assets.</p> <p>ACSs are not subject to tax. Investors are treated as if they owned the underlying assets directly and are taxed on income derived from these assets.</p> <p>The interest in a contractual arrangement treated as CGT asset</p>	<p>As a collective investment undertaking, SIFs are not subject to tax at the level of the fund on income and gains, but pay an annual subscription tax of 0.01% on NAV.</p> <p>Investors are subject to tax on their income from the fund in their own home country.</p> <p>Corporate form SIFs are able to elect its classification under the US 'check-the-box' taxation rules. This allows a corporate form SIF to be treated as a partnership for US tax purposes and thereby avoid certain adverse tax consequences for US taxable investors.</p>	<p>QIFs are exempt from Irish tax on income and capital gains, regardless of the residency of investors.</p> <p>No withholding taxes apply, under domestic legislation, on payments made by a QIF to a non-Irish resident, provided the relevant declarations are in place.</p>

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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
	<p>and investor subject to CGT on disposal of their interest.</p> <p>For partnerships, each investor is treated as making a disposal for CGT purposes when the fund sells an asset.</p> <p>Partnerships are generally only suitable for investors exempt from CGT.</p> <p>All fund types must distribute net income, which may be subject to tax for the investor.</p> <p>No withholding taxes apply, under domestic legislation, on distributions by the fund.</p>		
<b>Tax treaty eligibility</b>	<p>OEICs and unit trusts – Yes</p> <p>ACS – No</p> <p>Partnerships – No</p>	-	<p>Generally yes (on a case-by-case basis).</p> <p>CCFs do not benefit from the Irish tax treaty network.</p>
<b>VAT treatment where managed from the UK</b>	Subject to UK VAT at the standard rate of 20%	Outside the scope of UK VAT with recovery. Exempt from Luxembourg VAT	Outside the scope of UK VAT with recovery. Exempt from Irish VAT
<b>Service Providers</b>	<p>QISs must be managed by an authorised AIFM. Administration may be delegated, but the FCA must be informed.</p> <p>The Manager of a QIS must appoint a UK-based Trustee/Depositary.</p>	<p>SIFs must have a Luxembourg domiciled depositary and administrator.</p> <p>As an AIF it must have an appointed AIFM (which can be external or can be the board of directors).</p>	<p>QIFs are required to have:</p> <ul style="list-style-type: none"> <li>• A Promoter</li> <li>• Two Irish resident directors</li> <li>• MLRO</li> <li>• Investment manager</li> <li>• Irish registered administrator</li> <li>• Irish registered trustee/depositary</li> </ul>



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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
	QISs must appoint an auditor for certification of its accounts.		<ul style="list-style-type: none"> <li>• Auditor</li> <li>• Company Secretary</li> </ul>
<b>Reporting</b>	<p>UK authorised funds must produce annual and semi-annual accounts.</p> <p>Annual accounts must be audited.</p>	<p>SIFs are required to produce audited annual accounts.</p> <p>AIFMD mandated Annex IV reporting (assuming that the SIF is an AIF).</p> <p>Umbrella SIFs may prepare separate accounts in respect of each sub-fund.</p>	QIFs must produce annual audited financial statements.
<b>Establishment Time</b>	The FCA is required to process applications to authorise QISs within 6 months of receiving them. It aims to process applications within 1 month.	CSSF approval for SIFs take approximately 2 to 3 months from submission of a full set of documentation.	A QIF can be authorised within 24 hours of submission of the relevant documentation, provided parties to the fund are previously approved.
<b>Carried Interest Considerations</b>	None.	<p>In the context of SIFs formed in corporate form, carried interest is generally structured by having a special share class which has a low initial price and which is issued exclusively to qualifying persons/entities. The shares are typically restricted from transfer, etc.</p> <p>This class then receives its distributions when certain criteria are met (IRR, hurdle, etc.). If you are to be paid a distribution that is not part of the termination of the fund, this needs to be looked at in the context of a dividend.</p> <p>This structure works in a waterfall context as well.</p> <p>For limited partnerships, carried interest is usually taken in a similar fashion to other</p>	<p>There is no specific legislation dealing with carried interest.</p> <p>It is possible to structure funds such that carried interest can be treated for Irish tax purposes as a CGT receipt subject to take at the standard rate in the hands of an individual manager.</p>

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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
		<p>limited partnership structures and is conducted by way of having a special limited partner, which can be a carried interest vehicle domiciled in any jurisdiction for tax efficiency if necessary.</p> <p>The carried interest will go through a waterfall and the special limited partner will take its distribution.</p> <p>Performance fees can be paid (as a fee) as an alternative to carried interest.</p>	
<b>Status of the Jurisdiction and Court System</b>	England & Wales and Scotland have separate legal and court systems.	Subject to Luxembourg law and the court system.	Subject to Irish law and the court system.
<b>Derogation from regulation</b>	Available for newly launched funds and waivers granted in specific, limited circumstances.	-	Possible, in limited circumstances, after discussion with the CBI.
<b>Investment Restrictions</b>	<p>No limit on unapproved securities or funds (subject to due diligence requirements), property or commodities.</p> <p>Loan origination permitted in principle.</p> <p>Permitted to borrow up to 100% of NAV.</p> <p>Must have a prudent spread of risk.</p> <p>Requirement to distribute income.</p>	<p>No restriction on eligible assets.</p> <p>In principle, investment in securities of the same nature issued by the same issuer should not exceed 30% of its assets or its commitments.</p>	<p>No limit on unapproved securities, derivatives, private equity, property and commodities.</p> <p>No limit on borrowing or leverage.</p> <p>No requirement to distribute income.</p>

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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
<b>Ability for Individual Investor to Restrict Shareholder Meetings</b>	Permitted, where the investor is the sole investor.	Permitted (somewhat more difficult in a corporate vehicle).	Permitted.
<b>Bylaws/Constitutional Documents</b>	<p>No requirement to have an Annual general meeting, although Extraordinary General Meetings are necessary for certain changes to be made to funds.</p> <p>Funds are required to have an instrument constituting the fund.</p> <p>For a unit trust, the document is a trust deed made between the manager and trustee.</p> <p>ICVCs have an instrument of incorporation.</p> <p>ACS must be constituted by a Contractual Scheme Deed, made by the Manager and Depositary (co-ownership scheme) or the Nominated Partner (limited partnership scheme).</p> <p>QISs must also produce a prospectus and PRIIPs KID.</p>	<p>SIFs must have Articles of Association (if a SICAV or SICAF) or Management regulations (if an FCP).</p> <p>SIFs must have a prospectus.</p>	<p>No requirement for unit trusts to hold an AGM.</p> <p>Investment companies must hold an AGM.</p> <p>Investment companies must have a Memorandum and Articles of Association.</p> <p>Unit trusts are created by a trust deed entered into by the trustee and the manager.</p> <p>The ILP is constituted pursuant to a limited partnership agreement (LPA) entered into by one or more General Partners and any number of Limited Partners.</p> <p>A CCF is constituted under contract law by means of a deed of constitution, executed by the management company.</p> <p>QIFs must have a prospectus.</p>
<b>Eligible Investors</b>	<p>Investors must be classified as a professional or sophisticated retail investor.</p> <p>Requirement for genuine diversity of ownership (tax issue).</p>	Investors must be “well informed”, which comprises institutional investors, professional investors and other investors who confirm that they adhere to the status of “well informed” investors and who either invest a minimum of €125,000	<p>Qualifying investors must invest at least €100,000 and:</p> <ul style="list-style-type: none"> <li>• Certify they are an informed investor and provide certain written confirmations; or</li> <li>• Be a professional client, as defined by MiFID; or</li> </ul>

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	UK Qualified Investor Scheme	Luxembourg Specialised Investment Fund	Irish Qualifying Investor Fund
	For ACS, investors must be professional or sophisticated investors or invest at least £1m in the fund.	or are certified by a credit institution, investment firm or management company.	<ul style="list-style-type: none"> <li>Receive an appraisal from an EU credit institution, MiFID firm or UCITS management company that they have the appropriate expertise, experience and knowledge.</li> </ul> <p>CCFs only permit institutional (not individual) investors.</p>

## APPENDIX 2: COMPARISON OF UK AND OFFSHORE FUND STRUCTURES – UNAUTHORISED FUNDS

	<b>UK Exempt Unauthorised Unit Trust</b>	<b>Luxembourg Reserved Alternative Investment Fund</b>	<b>Irish Qualifying Investor Alternative Investment Fund</b>	<b>Cayman Exempted Limited Partnership</b>
<b>Jurisdiction</b>	United Kingdom	Luxembourg	Ireland	Cayman Islands
<b>Legal Structure</b>	Unit Trust	Common Fund (FCP) or investment company/partnership (SICAV or SICAF)	Investment company, unit trust, limited partnership or common contractual fund.	Limited Partnership (exempted limited partnership (ELP)), limited company (exempted companies and segregated portfolio companies (SPC)) or unit trust (exempted unit trust).
<b>Regulatory Authority</b>	Must be approved by HMRC	Commission de Surveillance du Secteur Financier (CSSF) approval not required. RAIFs are established by notarial certification.  Manager must be an AIFM, authorised by the CSSF or other EU authority.	Central Bank of Ireland	Cayman Islands Monetary Authority
<b>Basic Structure</b>	Unit Trust	Corporate vehicles need to be formed before a notary public and usually issue shares to investors, representing a proportion of the net assets of the fund. Shareholder liability is limited to the shareholding.  Shares can be issued in different classes with different management fees, investment level and charges	QIAIFs may be open or closed-ended.  An investment company is incorporated and investors hold shares in the company.  A unit trust is constituted by a Trust Deed, entered	Licensed Mutual Fund.  Administered Mutual Fund – a fund for which the principal office is provided by a licensed mutual fund administrator in the Cayman Islands.

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	<b>UK Exempt Unauthorised Unit Trust</b>	<b>Luxembourg Reserved Alternative Investment Fund</b>	<b>Irish Qualifying Investor Alternative Investment Fund</b>	<b>Cayman Exempted Limited Partnership</b>
		<p>and different lock-up periods / liquidity terms.</p> <p>Corporate vehicles (with the exception of the corporate partnership limited by shares, or SCA) will not have a general partner.</p> <p>For SIFs formed as partnerships, two types of limited partnerships are available in Luxembourg: the société en commandite simple (SCS) and the société en commandite spéciale (SCSp). The only difference between the two types of partnership is that the former has legal personality while the latter does not.</p> <p>These limited partnerships are formed between one or more general partners and at least one limited partner through execution of the limited partnership agreement (before a notary public or under private seal) and the contribution to the partnership.</p> <p>Investors can hold capital accounts or interests in the partnership and the interests may be issued as securities (titres).</p>	<p>into by the Manager and the Trustee.</p> <p>Units/shares are issued to investors, representing a proportion of the net assets of the fund. Shareholder liability is limited to the shareholding.</p> <p>A CCF is an unincorporated body established under a deed where investors are “co-owners” of underlying assets.</p> <p>The ILP is a regulated partnership structure, constituted by a Limited Partnership Agreement (LPA). General Partners are liable for the debts of the ILP where assets are insufficient to cover. Limited Partners have limited liability. Assets and liabilities belong jointly to the partners in the proportions agreed in the LPA.</p>	<p>Registered Mutual Fund which also includes master funds.</p> <p>Exempt Mutual Fund – exempt from licensing or registration.</p>

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	UK Exempt Unauthorised Unit Trust	Luxembourg Reserved Alternative Investment Fund	Irish Qualifying Investor Alternative Investment Fund	Cayman Exempted Limited Partnership
		The general partner is liable (beyond the limited partnership's assets) for the debts and obligations of the limited partnership and limited partners' liability is limited to the extent of their capital contributions.		
<b>Legal Personality</b>	None	FCP has no legal personality.  SICAV or SICAF has a legal personality, other than for Special Limited Partnerships.	Yes for investment company. No for unit trusts, ILPs and CCFs.	No. Day to day actions are conducted by the general partner.
<b>Ownership of Assets</b>	Trustees hold legal title of the assets, for the benefit of unit holders.	Corporate vehicles: assets are owned by the fund vehicle or subsidiaries.  Partnerships – determined in partnership agreement.  Assets are generally held by the Depositary, or ownership must be verifiable.	For investment companies, the assets are the property of the company.  For unit trusts, the Trustee is the legal owner, on behalf of investors.  Investors are co-owners of the assets held by a CCF.  The partners co-own the assets of an ILP, in the proportions agreed in the LPA.	Assets are owned by the partners on a proportional basis to their capital account unless set out otherwise in the partnership agreement.
<b>Regulatory Status</b>	Unregulated.	Unregulated, although the manager must be an AIFM, regulated in Luxembourg or any other EU State.	Authorised by the Central Bank of Ireland.	ELPs may be subject to registration or regulation as a mutual fund by CIMA under the Cayman Islands Mutual Funds

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	<b>UK Exempt Unauthorised Unit Trust</b>	<b>Luxembourg Reserved Alternative Investment Fund</b>	<b>Irish Qualifying Investor Alternative Investment Fund</b>	<b>Cayman Exempted Limited Partnership</b>
				<p>Law depending on their characteristics. Closed ended funds are generally outside scope.</p> <p>The most common category of regulation for mutual funds is as a “registered fund”. To be eligible for registration, a mutual fund must have a minimum aggregate equity investment of CI\$180,000 (\$100,000, or its equivalent in any other currency), or have its equity interests listed on a recognised stock exchange approved by CIMA. Registered funds are required to file an offering document with CIMA and notify CIMA following material changes to the fund and are also required to appoint CIMA approved and Cayman based auditors. Otherwise, there are minimal compliance requirements for registered funds.</p>



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	<b>UK Exempt Unauthorised Unit Trust</b>	<b>Luxembourg Reserved Alternative Investment Fund</b>	<b>Irish Qualifying Investor Alternative Investment Fund</b>	<b>Cayman Exempted Limited Partnership</b>
<b>Diversification Requirement</b>	None.	<p>No restriction in terms of eligible assets.</p> <p>Principles of risk spreading apply, unless the constitutional documents provide for exclusive investments in risk capital.</p> <p>Loan origination permitted, although it is unclear whether lending activities can be the main objective without falling foul of Financial Sector law.</p> <p>Flexibility as to distribution of income. Management regulations must include a distribution policy.</p>	<p>None.</p> <p>Not subject to borrowing restrictions.</p> <p>If structured as an investment company, then risk must be spread. ICAVs, unit trusts, CCFs, ILPs have no requirement for diversification. For a PLC, company law requires diversification of investment risk.</p> <p>Loan origination not permitted, unless the fund is specifically organised to do so and subject to specific rules.</p> <p>No requirement to distribute income.</p>	<p>None.</p> <p>No rules on risk spreading.</p> <p>Loan origination permitted in principle.</p> <p>No requirement to distribute income, unless stipulated in the fund's offering document or disclosed to investors.</p>
<b>Regulatory Wrappers and Marketing Passports</b>	If authorised as an AIF, then the AIFM may market under the private placement regime.	Under AIFMD, the fund can be passported if managed by an EU-based AIFM.	Under AIFMD, the fund can be passported if managed by an EU-based AIFM. If managed by a non-EU AIFM, private placement available.	Possibility of marketing under private placement.
<b>Umbrella/Series Structure and Segregated Liability</b>	None.	Umbrellas with segregated liability permitted.	Umbrellas with segregated liability permitted.	No. The limited partnership can, however, have separate classes to which different

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	UK Exempt Unauthorised Unit Trust	Luxembourg Reserved Alternative Investment Fund	Irish Qualifying Investor Alternative Investment Fund	Cayman Exempted Limited Partnership
				portfolios of assets could be allocated, but there would be no segregation of liability between portfolios.
<b>Management</b>	Trust is managed by one or more trustees.	The RAIF must be managed by an external AIFM, authorised in the EU.  The RAIF must appoint a depositary.	QIAIFs must be managed by an authorised AIFM.	The general partner is required to be either an individual resident in the Cayman Islands, a company incorporated or registered as a foreign company in the Cayman Islands, an ELP in the Cayman Islands or a registered foreign limited partnership. The general partner is typically not subject to regulation.  Investment Managers may appointed from almost all jurisdictions to manage the assets of an ELP.
<b>Directorship Requirements</b>	No directors needed. Trustees must be UK resident.	<b>Will depend on the legal form the RAIF will adopt:</b> 1) Corporate SICAV => <i>minimum 3 directors</i> (additionally, clear allocation of functions between the directors: portfolio management, risk management, distribution, administration, legal and	Board of Directors, with at least two Irish-resident directors.	No residential qualifications necessary. Corporate directors acceptable. CIMA requires a minimum of two individual directors for registered funds or one corporate director (itself

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	UK Exempt Unauthorised Unit Trust	Luxembourg Reserved Alternative Investment Fund	Irish Qualifying Investor Alternative Investment Fund	Cayman Exempted Limited Partnership
		<p>compliance. The board of a SICAV should not be predominantly composed of the same persons as the board of the AIFM and in case of same persons sitting on both boards, conflicts of interest should be prevented).</p> <p>2) Contractual "Fonds Commun de Placement" (Common Contractual Fund equivalent) =&gt; <i>no board of directors</i> at the level of the fund</p> <p>3) Special Limited Partnership (SLP): unregulated flexible tax transparent investment vehicle used for AIFs and their managers (Luxembourg SLP is relatively similar to the Anglo Saxon LPs) =&gt; management by a GP or a board as defined in the Limited Partnership agreement (more info on Lux SLP: <a href="https://www.pwc.lu/en/private-equity/docs/pwc-private-equity-lux-limited-partnership.pdf">https://www.pwc.lu/en/private-equity/docs/pwc-private-equity-lux-limited-partnership.pdf</a>).</p>		having a minimum of two directors).
<b>Tax Transparency</b>	No, opaque	No for SICAV Yes for FCP and LP	Yes, where formed as an investment limited partnership or common contractual fund.	Generally yes.

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	<b>UK Exempt Unauthorised Unit Trust</b>	<b>Luxembourg Reserved Alternative Investment Fund</b>	<b>Irish Qualifying Investor Alternative Investment Fund</b>	<b>Cayman Exempted Limited Partnership</b>
<b>Tax treatment</b>	<p>Fund tax exempt on gains and income.</p> <p>No withholding tax.</p> <p>Risk of tax on accounting mismatches of over 20%.</p>	<p>Subject to a reduced subscription tax on 0.01% p.a. of NAV, unless tax exempt.</p> <p>If a RAIF invests exclusively in risk capital, it is subject to the SICAR tax regime, meaning there is no subscription tax, but the fund pays the ordinary income tax, unless a tax exemption applies.</p>	<p>Exempt from Irish tax on income and gains, irrespective of investors' residence.</p> <p>No withholding tax on income distributions and redemption payments made to non-Irish investors.</p> <p>Exit tax of 41% applies to distribution or redemption payments made to Irish resident investors, unless exemptions apply.</p>	<p>No taxes in the nature of income tax, corporation tax, capital gains tax or inheritance tax are payable in the Cayman Islands.</p> <p>An exempted company is entitled to apply for an undertaking from the Governor of the Cayman Islands that it will be exempt from any local tax (if any should be introduced) for up to twenty years. An Exempted Limited Partnership/ Unit Trust is entitled to apply for an undertaking from the Governor of the Cayman Islands that it will be exempt from local tax (if any should be introduced) for up to 50 years.</p>
<b>VAT treatment where managed from the UK</b>	Subject to UK VAT at the standard rate of 20%	Outside the scope of UK VAT with recovery. Exempt from Luxembourg VAT	Outside the scope of UK VAT with recovery. Exempt from Irish VAT.	Outside the scope of UK VAT with recovery. No Cayman consumption tax.
<b>Service Providers</b>	Trustees must be UK resident.	Must be managed by an authorised AIFM.	For QIAIFs not internally-managed, external, authorised AIFMs must be appointed.	No specific requirements. ELPs are subject to anti money-laundering requirements and in

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	<b>UK Exempt Unauthorised Unit Trust</b>	<b>Luxembourg Reserved Alternative Investment Fund</b>	<b>Irish Qualifying Investor Alternative Investment Fund</b>	<b>Cayman Exempted Limited Partnership</b>
			<p>QIAIFs must have a Board of Directors, with at least two Irish-resident directors.</p> <p>Investment management may be delegated.</p> <p>The QIAIF must appoint an independent depositary, located in Ireland.</p> <p>Accounts must be audited by an auditor.</p>	<p>practice compliance with such rules is often achieved through delegation to an administrator, which must be subject to the AML regime of the Cayman Islands or an equivalent jurisdiction.</p>
<b>Reporting</b>	An EUUT must prepare an annual self-assessment tax return, audited accounts and a statement confirming that during the period all investors were “eligible investors”.	The RAIF (SICAV) or its management company (FCP) must prepare an audited annual report.	A QIAIF must prepare annual accounts, independently audited.	Registered mutual funds are required to appoint a CIMA approved and Cayman based auditor and file audited financial statements yearly.
<b>Establishment Time</b>	Comment needed.	No CSSF approval required before launch, therefore time-to-market is dependent on the manager.	A QIF can be authorised within 24 hours of submission of the relevant documentation, provided parties to the fund are previously approved.	Same day incorporations possible. Start to finish indicative timing: 4-12 weeks for Licensed Mutual Funds; and 2-4 weeks for Administered Funds, Mutual Funds, Registered Mutual Funds and Exempt Mutual Funds.

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	UK Exempt Unauthorised Unit Trust	Luxembourg Reserved Alternative Investment Fund	Irish Qualifying Investor Alternative Investment Fund	Cayman Exempted Limited Partnership
<b>Carried Interest Considerations</b>	-	<ol style="list-style-type: none"> <li>1) The Luxembourg AIFM law defines “carried interest” as a share in the profits of the AIF accrued to the AIFM as a compensation for the management of the AIF and excluding any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF.</li> <li>2) The Law permits the taxation of carried interest realized by certain physical persons that are employees of the AIF or their management company as "speculative income under Luxembourg's Income Tax Law provided that certain conditions are met. The applicable tax rate is 25% of the average tax rate applicable to the taxpayer's adjusted income - i.e., a maximum of 11.44%. In addition, dependence insurance (1.4%) would also be due.</li> <li>3) To benefit from the tax regime, physical persons must not have been Luxembourg tax residents, or subject to tax in Luxembourg on their professional income, during the five years before the year of implementation of the</li> </ol>	<p>There is no specific legislation dealing with carried interest.</p> <p>It is possible to structure funds such that carried interest can be treated for Irish tax purposes as a CGT receipt subject to take at the standard rate in the hands of an individual manager.</p>	-

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		<p>Luxembourg AIFM Law. The physical persons must, furthermore, establish their tax domicile in Luxembourg during the year of implementation of the AIFM Law or during the following five years. The favorable tax treatment will no longer be applicable after 31 December 2018. Developments around a new regime are expected. However, it is not yet known when it will be enforced.</p> <p>4) Provided that the carried interest is considered as compensation for the management of the AIF, the remuneration falls within the scope of VAT but should benefit from the VAT exemption scheduled for the management of UCIs.</p>		
<b>Status of the Jurisdiction and Court System</b>	England & Wales and Scotland have separate legal and court systems.	Luxembourg (civil law).	Subject to Irish law and court systems.	The Cayman Islands is a British Overseas Territory which is self-governing and part of the Commonwealth. The head of state is HM the Queen of England and the UK is responsible for the appointment of the Cayman Islands'

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	UK Exempt Unauthorised Unit Trust	Luxembourg Reserved Alternative Investment Fund	Irish Qualifying Investor Alternative Investment Fund	Cayman Exempted Limited Partnership
				<p>governor, national security and the administration of the courts.</p> <p>The Cayman Islands has its own independent court system.</p> <p>The Privy Council in London.</p>
<b>Derogation from regulation</b>	Not regulated.	A RAIF does not need to be authorised and is not subject to the direct supervision of the CSSF, but it is required to be managed by an authorized AIFM (the AIFM being supervised by the CSSF).	Possible, in limited circumstances, after discussion with the CBI.	<p>(a) funds with a minimum investment of US\$100,000 (or currency equivalent) or are listed on a stock exchange approved by CIMA and have paid the prescribed fee and registered certain required documentation with CIMA are exempt from holding a mutual funds licence and</p> <p>(b) funds with fewer than fifteen investors, the majority in number of whom have the right to appoint and remove the directors are exempt from holding a mutual funds licence.</p>



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	<b>UK Exempt Unauthorised Unit Trust</b>	<b>Luxembourg Reserved Alternative Investment Fund</b>	<b>Irish Qualifying Investor Alternative Investment Fund</b>	<b>Cayman Exempted Limited Partnership</b>
<b>Investment Restrictions</b>	<p>Investors must be exempt from CGT or Corporation Tax on capital gains, for reasons other than residency.</p> <p>This must be confirmed annually.</p>	<p>Investors must be “well informed”, which comprises institutional investors, professional investors and other investors who confirm that they adhere to the status of “well informed” investors and who either invest a minimum of €125,000 or are certified by a credit institution, investment firm or management company.</p>	<p>Qualifying investors must invest at least €100,000 and:</p> <ul style="list-style-type: none"> <li>• Certify they are an informed investor and provide certain written confirmations; or</li> <li>• Be a professional client, as defined by MiFID; or</li> <li>• Receive an appraisal from an EU credit institution, MiFID firm or UCITS management company that they have the appropriate expertise, experience and knowledge.</li> </ul> <p>CCFs only permit institutional (not individual) investors.</p>	<p>No restriction other than a minimum initial investment of \$100,000.</p>
<b>Shareholder Meetings</b>	N/A	At least one per year (at the level of the fund or of the ManCo for FCPs (CCF equivalent)).	<p>No requirement for unit trusts to hold an AGM.</p> <p>A PLC must hold an AGM, and ICAV does not need to.</p>	No requirement for annual meeting save as may be provided in the articles of association.

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<b>Bylaws/Constitutional Documents</b>	Trustees must prepare and enter into a trust deed.	Offering document must contain all information necessary for investors to make an informed judgement and must indicate on the first page that the fund is not subject to supervision in Luxembourg.	<p>Investment companies must have a Memorandum and Articles of Association.</p> <p>Unit trusts are created by a trust deed entered into by the trustee and the manager.</p> <p>The ILP is constituted pursuant to a limited partnership agreement (LPA) entered into by one or more General Partners and any number of Limited Partners.</p> <p>A CCF is constituted under contract law by means of a deed of constitution, executed by the management company.</p> <p>QIAIFs must have a prospectus.</p>	Memorandum and articles of association. May be amended by shareholders only.

## ANNEX 3: RETIREMENT FUND SUB-GROUP REPORT



### CHAIR'S FOREWORD

In 2015, the Pension Freedoms brought about a sea change in how people access their pension savings. The additional choice and flexibility brought by the reforms is welcome, recognising customers' differing circumstances and allowing them to purchase the right retirement product at the right point in their lives. At the same time, individual savers face a potentially complicated set of decisions that may have very significant ramifications.

Our Working Group has considered the extent to which the fund industry has the right delivery vehicles to help ensure that customers can achieve good outcomes in this new world. We have a number of specific recommendations, but the broad conclusion is that the main immediate challenge lies less in the product set than in ensuring appropriate levels of advice and support for customers as they face greater responsibility.

In particular, while many customers will choose to seek advice, current evidence suggests there is much more to do to help the emerging mass market of customers who may not seek advice, or who may not view it as affordable. While the early years of the freedoms have seen the withdrawal of cash predominate, this largely reflects pent up demand, small DC pots and the existence of DB entitlements and other assets that people will rely on in retirement.

Future cohorts will be more reliant on their DC pension assets for income and it is likely that income drawdown and other investment-based approaches to retirement income will gain in popularity. This report is therefore timely in setting out a view of what is needed for UK investment funds to maximise their role in the new retirement landscape.

We identify three key areas where the regime could be improved immediately to the benefit of customers:

First, enhancing the tax efficiency of the fund structures used to deliver retirement investment strategies will help maximise investor returns.

Second, making it easier to incorporate illiquid investments into retirement investors' portfolios can help enhance diversification and generate income.

Third, simplifying the complex disclosure and compensation landscape caused by the layering of legal structures within pensions and retirement products can help boost customer understanding and confidence.

Looking ahead to a more mature retirement income market, we suggest that allowing investment funds to distribute capital as income may help to facilitate greater innovation in the design of funds focused on generating sustainable retirement income.

We look forward to working in partnership with HM Treasury and the FCA to ensure that UK investment funds play their fullest part in helping customers achieve their financial goals in retirement.

**Richard Parkin, Chair, Retirement Fund Working Group**

### INTRODUCTION

1. The Retirement Fund Working Group (RFGW) is a sub-group of the UK Funds Regime Working Group (UKFRWG).
2. The objective of the RFGW is to identify what changes, if any, are needed to maximise the relevance and usability of UK investment funds for the fast-growing retirement market.
3. Membership of the group draws on a wide range of experience across different elements of the retirement market covering investment management and operations, platforms, taxation and retirement advice.
4. Input was gathered from the RFGW membership through group meetings and one-to-one interviews. This was supplemented by interviews with other asset managers and platform operators. We also sought input from the Association of British Insurers on some of the tax aspects discussed below.

### UK INVESTMENT FUNDS AND THE RETIREMENT MARKET

5. Authorised investment funds are used extensively in retirement provision in both the accumulation and decumulation phases. However, in the pensions accumulation phase, these funds are typically not held directly but through an insured pension fund wrapper. The insured fund structure could become more prevalent in the decumulation phase in future if master trusts and contract-based providers look to develop mass market retirement propositions that integrate seamlessly with an accumulation phase product. The use of insured “wrappers” has significant advantages (see Appendix 1) but also leads to a layering of product structures that can create complexity and inefficiency, particularly in terms of disclosure, consumer protection and tax.
6. There seems little appetite for DC pension schemes to move away from using insured pension funds, even where member record keeping is not carried out by the same provider as that offering investment funds. Some asset managers have moved away from using life funds, driven by the costs of running their own life company and reinsurance counterparty risks for their clients (see paragraph 10). However, the funds they offer are almost invariably wrapped by insured pension providers before being made available to DC pension investors. The main exception to this is within some of the larger master trusts that are creating their own unitised investment vehicles (e.g. NEST).
7. In the decumulation phase, while insured pension funds are used by many providers and may see further growth as a result of consolidation in the DC market through master trusts, authorised funds will typically be held directly or via tax wrappers such as Self Invested Personal Pensions (SIPPs) and ISAs. In the majority of cases, these funds will be accessed via an investment platform or pension provider rather than directly.
8. The end customer’s income requirements will usually be managed by the platform or product provider rather than by the underlying fund provider. While clients may, for example, choose an income-oriented fund, how and when that income is paid out to the investor can vary allowing a range of retirement needs to be met. Those needing less income than the fund pays can have the excess reinvested while those wanting

more can supplement the income with capital withdrawals through cancellation of units. This flexibility allows a variety of investment strategies to be employed to deliver retirement outcomes rather than individual funds having to deliver these outcomes directly. That said, we are familiar with attempts to develop investment funds that are designed specifically to generate a stable retirement income with a high degree of confidence. We discuss this further below.



### INVESTMENT STRATEGIES USED FOR RETIREMENT

9. Since the introduction of automatic enrolment, defined contribution investment has become almost wholly focused on default strategies. Around £400bn is estimated to be held in DC workplace pensions<sup>22</sup>, with the vast majority of these assets being held in default strategies, which have membership rates of 90% or more<sup>23</sup>. These default strategies are almost invariably structured as lifestyle or lifecycle strategies where a member's investments are gradually moved from growth assets such as equities towards an asset allocation that matches their retirement objectives as the member nears their chosen retirement date.
10. Default strategies are dominated by the use of multi-asset and passive investment<sup>24</sup>. As a result, the use of authorised funds tends to be focused on multi-asset vehicles though single asset class funds are used extensively by larger schemes and pension providers in creating bespoke or proprietary multi-asset strategies. Passive investment has typically been achieved through the use of directly invested life funds though some passive providers are now structuring their DC offerings as tax-transparent funds to avoid reinsurance counterparty risk for the pension provider (see Appendix 2).
11. As Figure 1 illustrates, decumulation strategies are much more varied and will be driven by the needs of investors which may range from taking cash over a short time-frame to leaving pension assets invested for the long-term as a bequest. Moreover, even where generating income is a key consideration, a range of different approaches is used by advisers as shown below.
12. Asset managers have different views on the best approach for clients wishing to generate sustainable income. Some argue that it is better to target income generating assets to reduce the need for retirees to draw on capital to supplement income payments while others are indifferent to how return is generated arguing that targeting total return is the more appropriate approach.

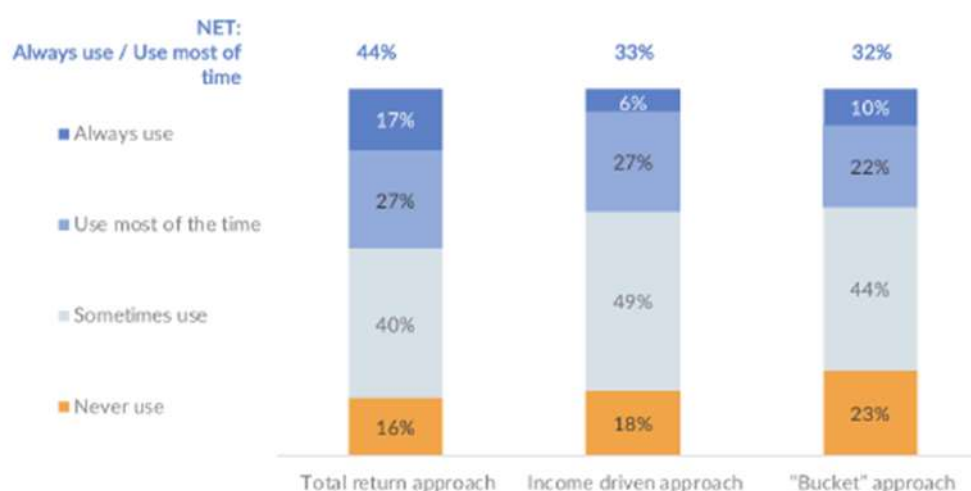
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<sup>22</sup> 'Asset Management in the UK 2017-18', The Investment Association, 2018.

<sup>23</sup> The proportion of members in the default strategy is 94% for GPPs and 99.7% for master trusts. Source: 'The Future Book: Unravelling workplace pensions 2017 Edition', PPI, 2017.

<sup>24</sup> Good evidence on the design of DC default strategies can be found in 'Master Trusts Investment Designs: A Comprehensive Study', DCIF 2017.

**Figure 1: Advisers use a range of strategies to support income withdrawal<sup>25</sup>**



Source: "Retirement Advice: the next five years", NextWealth July 2018

13. Given the wider range of consumer objectives and this diversity of views amongst advisers and asset managers, decumulation assets tend to be spread across a wider range of authorised funds than in the accumulation phase. There has, however, been a significant growth in the development of multi-asset income funds by asset managers. The use of packaged multi-asset products is significant and is likely to grow further with the introduction of investment pathways for non-advised drawdown, as the FCA has proposed following its Retirement Outcomes Review.
14. At the time of writing, the FCA is consulting on the design of investment pathways. The intention is to offer a range of pathways that match a customer's objectives for their retirement savings. Pathways will be offered to customers taking tax-free cash but who leave the remainder of their savings invested. We anticipate that this will result in most non-advised customers remaining in some form of proprietary packaged investment solution, as FCA analysis implies (see Figure 2). While these may, in turn, be invested in authorised funds, the introduction of investment pathways is likely to further concentrate responsibility for selecting funds in the hands of pension providers. Although the investment pathways do not apply to master trusts and other trust-based schemes, we consider that master trusts will also look to develop their own retirement solutions, leading them to take on the responsibility for fund selection in retirement on behalf of their members.
15. The FCA does not intend to introduce a charge-cap for investment pathways at this stage but has suggested that providers should consider the level of charges by reference to the DC charge cap of 0.75%pa. It is not yet clear what the costs of a mass market non-advised drawdown product would be, but the experience of the existing charge cap suggests that a cap could lead to price becoming the main point

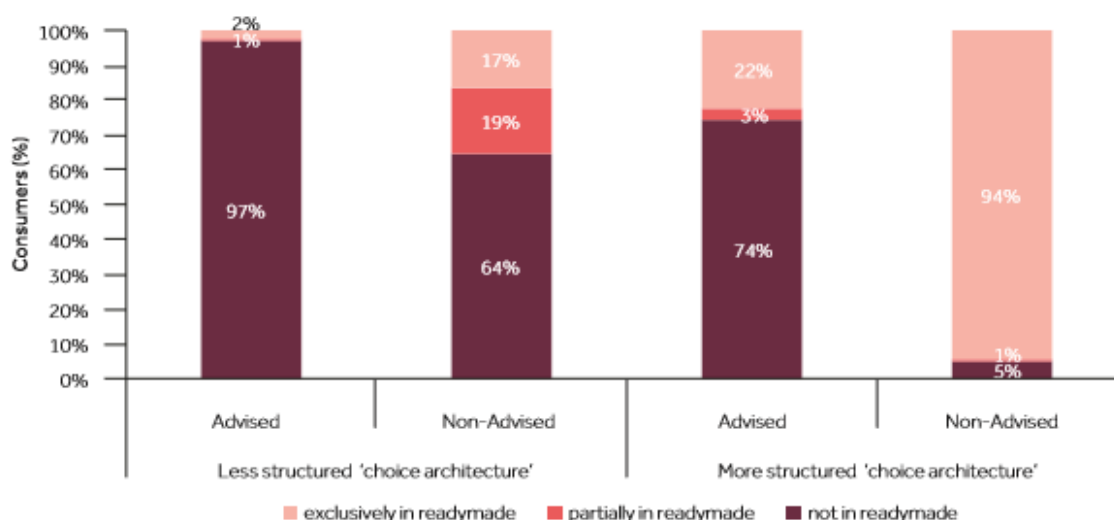
<sup>25</sup> Total return approach: portfolio designed to deliver returns with income drawn through systematic withdrawals

Income driven approach: portfolio designed to maximise income with payments supplemented by capital withdrawals

Bucket approach: portfolio divided between cash, intermediate and growth assets with income drawn from cash

of competition and may result in greater use of passive strategies in the transition to full retirement and potentially into retirement.

**Figure 2: Use of structured choices drives concentration in pre-packaged funds**



Source: Retirement Outcomes Review Final Report, FCA June 2018

## ENHANCEMENT OF EXISTING UK REGIME

16. Conversations with asset managers for this report generally suggested that existing UK fund structures could be used to manufacture products that could be used as part of a retiree's investment portfolio, whether for growth, income, total return approaches or other objectives.
17. We therefore do not present proposals for a specific new regime or sub-regime for investment funds. Instead, we identify areas where enhancements could help to ensure efficiency of delivery, particularly a number of business and operational issues that may result in customers not receiving all of the tax benefits to which they could be entitled.
18. One specific aspect of the current regime raised with us that did act as a block on innovation for a retirement-focused investment fund, related to treatment of capital and income. This is discussed in the next section and we suggest that further work is undertaken by industry, regulator and tax authorities to look at how this issue could be addressed.
19. Finally, there are a number of regulatory challenges that are not unique to the retirement market but which are amplified by the layering of pension, insurance and investment components in delivering retirement products. These concern important areas, including asset allocation restrictions, compensation arrangements, cost of guarantees and disclosure rules.

### UNLOCKING INNOVATION IN RETIREMENT-FOCUSED FUNDS: THE TREATMENT OF CAPITAL IN FUND DISTRIBUTIONS



20. When pension freedom was first introduced there was some discussion of whether limiting authorised fund distributions to include only income was restrictive<sup>26</sup>. If funds were able to distribute capital, then it would be possible to create structures that were able to meet pay-outs drawing on capital to supplement any shortfall between the target pay-out and the income received on underlying investments.
21. Such approaches could be used in a variety of strategies for paying income and, to some extent, would provide an alternative / competitor to drawdown strategies substantively doing the same thing by buying and selling units in underlying funds. One operational advantage of running this from within an investment fund, as opposed to multiple funds on a platform, is potential efficiency gains by minimising fund administration<sup>27</sup>.
22. From a customer perspective, the advantage of such approaches is that they work well for those customers without bequest motives that are seeking to exhaust their capital. They provide more flexibility than an annuity because if the customer dies their remaining fund can be passed on to their beneficiaries. In comparison to drawdown they can be more efficient because capital is run down. One of the challenges of drawdown is that it can be inefficient in the sense of leaving too much money on the table, as a result of excessive caution over on-going withdrawals<sup>28</sup>.
23. Our research with fund operators suggests mixed views on this point. Some firms we spoke to have concluded that clients wanting fixed pay-outs can achieve this through their product provider or other fund administrator managing this process and raising capital through cancellation of units as appropriate. Others have concluded that there is merit in funds being able to make distribution out of capital because it could allow for the development of retirement-focused investment funds that don't currently exist. In particular, "bond ladders", a popular method for generating predictable income, cannot be created in an authorised fund structure as these involve manufacturing income payments from a combination of interest and capital.
24. On the grounds that further innovation could benefit customers, we recommend that HMT, HMRC and the FCA work with The Investment Association and its members to consider the case for allowing authorised funds to make distributions out of capital in certain circumstances.

### TAX TREATMENT OF AUTHORISED FUNDS

25. The majority of most people's retirement wealth will be held in pension vehicles which, as discussed above, will often be invested, albeit indirectly, in one or more

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<sup>26</sup> See for example the IA's response to HM Treasury's consultation in 2014 on 'Freedom and choice in pensions'. Available to download at [https://www.theia.org/sites/default/files/2019-05/20140611-freedomandchoiceinpensions\\_0.pdf](https://www.theia.org/sites/default/files/2019-05/20140611-freedomandchoiceinpensions_0.pdf)

<sup>27</sup> Although we acknowledge that a fund held directly by individual investors would require the return to be split between the income element and capital element due to the different tax treatment of these components in investors' hands. This might off-set some of the operational advantage.

<sup>28</sup> See 'The UK Retirement Market: Retirement Regulation and Innovation – the Next Five Years', Nextwealth, 2018, for a discussion of this issue.



authorised funds. Pension schemes are exempt from income and capital gains taxes on investments and also often qualify for reduced withholding tax rates on overseas income. However, the use of authorised investment funds can mean that pension investors are not able to benefit from all of these tax advantages.

### RECLAIMING TAX ON MULTI-ASSET FUNDS

26. Where investors hold funds that invest in both dividend and interest paying investments (e.g. equities and bonds), distribution payments will include a mix of dividend and interest income. If interest bearing assets do not exceed more than 60% of the fund's property the fund is deemed to be dividend distributing and such distributions would not be deductible at the fund level. For exempt investors such as pension funds and ISAs, this means that the interest element of the distribution is taxed whereas they would be entitled to receive this income gross if they received it directly.
27. Multi-asset funds are, from an investment standpoint, an attractive option for retirement investors. However, this tax drag makes them relatively inefficient and, as we see below, can have a significant impact on investors.
28. HMRC rules allow corporate investors to reclaim any tax deemed to have been paid on interest income through a process known as corporate streaming. In particular, this allows insured pension funds to reclaim this tax. However, non-corporate pension funds, including many SIPPs, are not able to. Given the extensive use of SIPPs for retirement we consider this anomalous treatment to be a significant detriment to retirement investors.
29. The table below shows an example of this for a growth-oriented multi-asset income fund. The annual dividend distribution for the fund was just over 4.2p per unit. Although the fund didn't have more than the 60% in interest-bearing assets to qualify it as an interest distributing fund, the interest-bearing assets it did hold generated relatively high yields so that a large proportion of the dividend was attributable to unfranked investment income. The corporation tax notionally suffered by the fund on this income was just under 0.5p. This can be reclaimed by tax-exempt investors structured as corporates (i.e. life company pension funds) to obtain a nearly 12% increase in the total income received which would have added just under 0.4% to the fund's return.

**Table 1: Potential tax reclaim for multi-asset funds can be significant**

Item	Value
Total distribution payable per unit	4.204600p
Proportion of unfranked income	84.13%
Tax reclaim on notional unfranked income	0.492765 p
Tax reclaim as a % of total distribution	11.7%
Tax reclaim as a % of unit price on xd date	0.38%

30. This example shows that not reclaiming this tax could have a significant effect on the value of pension investments over the long term.

31. Even though insured pension funds are entitled to reclaim the notional tax paid, the rules here are complex and it is not clear that all firms are making the reclaims to which they are entitled, largely because of a lack of awareness of the issue.
32. This issue has been considered previously and, in 2009, HMRC introduced the Tax Elected Funds (TEF) regime which allows AIFs to elect to be treated as TEFs and pay dividend and interest income as separate distributions with the interest element paid gross to exempt investors. While this is attractive in theory, the practicalities of handling two distributions for a single fund for product providers, and platforms in particular, have meant that TEFs have seen little take-up. Our research with providers suggests that this is likely to remain the case for the foreseeable future.
33. The UKFRWG has been considering what further reforms could be made to remedy this treatment and has recommended deemed deduction for distributions at fund level. This would ensure that all exempt investors received the correct treatment of interest income and would avoid investors having to make reclaims, so improving the efficiency of fund operations and ensuring all retirement investors received the correct and consistent tax treatment automatically.
34. In the meantime, we will approach the Association of British Insurers to discuss how we can ensure all insurers are reclaiming this tax on behalf of their investors. The primary objective will be to ensure that reclaims are being made but it may be that we will need to approach HMRC for another discussion of how the rules and process could be improved to benefit consumers.

### OVERSEAS WITHHOLDING TAXES

35. Where assets are held in authorised investment funds such as OEICs and unit trusts, pension investors will generally not be able to access lower withholding tax rates on overseas income as the fund is treated as a single entity without any “look through” to the underlying investors. Alternative fund structures such as the Authorised Contractual Scheme (ACS) have been developed to allow this look through. These structures are used by some passive providers in the DC market but have not, to date, seen significant take-up in the broader retirement market.
36. The impact of higher withholding tax rates depends on the investment strategy followed. In particular, the benefit is driven by the level of overseas equity income and the comparative withholding tax rates between an authorised investment fund and a direct UK pension investor.
37. The table below shows the withholding tax impact from US equities alone for a number of different portfolios held in a UK OEIC. Note that for global and multi-asset portfolios we have assumed that the US equities held yield in line with the relevant US index. This may understate or overstate the actual benefit.

**Table 2: How US withholding tax varies across portfolio strategies and styles**



Fund strategy	US Equity	US Equity Growth	US Equity Income	Global Equity	Global Equity Growth	Global Equity Income	Multi-asset 60% equity 40% bond	Multi-asset 60% equity 40% bond
<b>Index dividend yield</b>	1.86%	1.29%	3.55%	2.34%	1.62%	4.18%	2.34%	2.34%
<b>Source</b>	FTSE USA All Cap	Russell 3000 Growth	FTSE RAFI US Equity Income	FTSE All-World	Ratioed from US	FTSE RAFI AW Equity Income	FTSE All-World	FTSE All-World
<b>% in US equity</b>	100%	100%	100%	53%	45%	39%	32%	21%
<b>WHT rate on dividend</b>	15%	15%	15%	15%	15%	15%	15%	15%
<b>WHT payable as % of portfolio</b>	0.28%	0.19%	0.53%	0.15%	0.09%	0.21%	0.09%	0.06%

Source: Richard Parkin Consulting. Results based on index information as shown in table and assuming investments are held in a UK OEIC. Note that for global and multi-asset portfolios we have assumed that the US equities held yield in line with the relevant US index. This may understate or overstate the actual benefit.

38. This shows that there is still a meaningful tax drag on OEICs from US withholding tax but that this diminishes when we consider the more diversified portfolios that many DC investors will typically hold.
39. There is limited demand for tax transparent funds from pension trustees and their advisers. Given this, and the relatively high costs of implementing and operating these structures, it seems likely that growth in the use of these vehicles in the retirement market will be slow.
40. The UKFRWG has considered the issue of withholding taxes for UK funds in detail and its recommendations included elsewhere in the Report are:
  - An explicit objective for HMRC to maintain protection for UK funds, where tax authorities seek to undermine existing treaty rights for funds.
  - An explicit mandate to HMRC to engage positively with overseas jurisdictions with a view to preserving and improving treaty rights particularly where the treaty access issues are likely to arise post Brexit in territories where UK funds have previously not had to rely on tax treaties.
  - A requirement for all future negotiations to include clear and specific provisions for collective investment vehicles and pension funds (including life companies with solely pensions business) as well as specifically recognise the transparency of the UK ACS.

The above will help protect and enhance the withholding tax position for UK funds.

### WIDER ISSUES AFFECTING THE USE OF FUNDS IN RETIREMENT

41. The Group examined a range of wider issues affecting investment funds, which may result in challenges for customer choice, understanding and the wider availability of products. These are outlined below.

### ASSET ALLOCATION RESTRICTIONS

42. Authorised investment funds are subject to limits that can be held in some assets or in other investment funds. In particular, the UCITS rules have made it difficult to construct funds of funds historically. While these restrictions have caused challenges for some firms, there seems no strong demand for changes to these rules with many operators now using Non-UCITS Retail Schemes where concentration limits might otherwise be problematic.
43. Some firms have expressed an interest in holding less-liquid investments in retirement portfolios. This subject is being looked at in more detail by the Long-Term Asset Fund subgroup which is proposing that these assets could be held in a Non-UCITS Retail Scheme.
44. We would anticipate that retirement investors would not hold these funds directly. Rather they would form a (relatively small) part of a multi-asset strategy delivered through another authorised fund or an insured pension fund. Even as part of a wider portfolio, liquidity restrictions on LTAFs may create operational issues for pension providers who generally require daily pricing and dealing. We have discussed some of these issues with the LTAF sub-group but a broader discussion with pension providers will be required to ensure that the LTAF can be successfully accommodated in retirement funds.
45. In addition, the permitted links regulations and the treatment of LTAFs for capital adequacy purposes will need to allow LTAFs to be held as part of a daily-priced and dealt retirement portfolio without creating unwanted investment restrictions on the LTAF or additional capital requirements for the product provider. The FCA consulted on changes to the permitted links rules in relation to illiquid investments in early 2019 and the Investment Association submitted a proposal on how the LTAF should be treated<sup>29</sup>. The treatment of the LTAF for capital adequacy will depend on how it is used by pension providers and so further discussions with them are needed to identify any potential issues.

### FSCS COVERAGE FOR RETIREMENT PRODUCTS

46. The compensation available to authorised fund investors in the event of a fund failure is often difficult to determine. This is because the fund may be held by a nominee or trustee for the benefit of the investor rather than directly by an investor. Further confusion comes where an authorised fund is held via a life insurance wrapper. In these cases, depending on how the insurance policy is worded, investors may be able to claim much higher compensation than if they invested directly or may not be subject to compensation at all.

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<sup>29</sup> See IA responses to [CP18/40 changes to permitted links rules](#) and [DP18/10 patient capital and authorised funds](#).

47. This lack of certainty makes it difficult to achieve the same level of consumer understanding of compensation arrangements for pensions as that achieved for bank deposits. Pension provider communications on this subject are often vague and, one must believe, are unlikely to engender trust in the pensions system.
48. Moreover, where an authorised investment fund is covered by FSCS, investors may be subject to the relatively lower limit under the Investment Compensation Scheme. Given the potential size of retirement savings and the difficulty with diversifying across multiple providers, this may create a gap in FSCS coverage for wealthier investors.
49. While FSCS coverage does not seem to be a major concern for many pension investors, we consider it would be helpful to have greater clarity and certainty of how pension investments are treated. This would enable firms to provide clearer consumer messaging on this issue which should, in turn, support greater consumer confidence in pensions.
50. We are aware that the FSCS is focusing on the retirement market and look forward to working on them on defining and solving the issues here.

### GUARANTEES FOR RETIREMENT INVESTORS

51. Pension freedom saw a sharp drop in demand for annuities. Nonetheless, there is evidence that investors still value guarantees in retirement. Some fund operators have been investigating how their products can be combined with insurance to deliver greater certainty, perhaps by combining income drawdown with later-life annuities or through variable annuities.
52. While there seems to be scope for innovation here, the cost of providing guarantees, driven by low interest rates, and increased capital requirements under Solvency II, is seen by many as prohibitive. In addition, the complexity of these products often means they require advice which will further limit their availability to the mass market.

### DISCLOSURE AND ILLUSTRATION RULES

53. Discussions with members have identified challenges in how disclosure rules apply to products aimed at the retirement market.
54. The first is the risk categorisation of funds under UCITS and, in time, PRIIPs. This categorisation is driven by the type of investments held rather than the purpose for which they are held. In some cases, funds that are aiming to reduce risk for investors by providing downside protection through derivatives are classed as higher risk because of the instruments they use – a classification that reflects the opposite of what the fund is trying to achieve. This is not only confusing for investors but also limits the practical use of these funds by advisers seeking to select products consistent with a consumer's attitude to risk.
55. Another issue is the inconsistency of illustration rules across products. A SIPP investor investing in authorised funds could receive information prepared on three completely different bases:
- A "pre-sales" illustration from the pension provider using the FCA mandated illustration which uses standardised deterministic projections as a basis

- Future performance scenarios for the underlying authorised fund prepared using the PRIIPs methodology
- A Statutory Money Purchase Illustration prepared by the pension provider on the basis prescribed by the Financial Reporting Council

56. The illustration bases used may be individually justifiable but taken together are unlikely to enhance consumer understanding. Furthermore, as far as drawdown is concerned, there is no disclosure that informs customers of one of the main risks in drawdown: 'sequencing' risk, whereby the order that returns are received can have a hugely significant impact on the length of time an investor's funds would be expected to last. Addressing this point would be of significant value to customers if it can help shape their investment and income choices in drawdown.
57. The RFWG recognises that this is not a simple issue that can be addressed quickly. Nonetheless, it must be addressed if the retirement market is to work well for customers. The FCA should therefore over time work to improve disclosure with the objective of reducing or eliminating potential consumer misunderstanding.

## CONCLUSIONS AND RECOMMENDATIONS

58. Overall, we conclude that UK authorised funds are already capable of meeting the needs of retirement consumers to a significant extent. However, looking ahead to a more mature retirement income market we note that the current treatment of income and capital within authorised funds may inhibit future innovation in the retirement income market.
59. Specifically, allowing funds to make distributions out of capital in addition to income, may aid the development of funds that aim to target an income stream while drawing down on individuals' capital. The main example here would be "bond ladders", under which predictable income over a pre-determined number of years can be achieved by constructing a portfolio of bonds that mature sequentially in every year of the portfolio's existence. Each year's income is provided by annual coupon payments and the return of capital on the bond that matures in that year. Such approaches can be an efficient and flexible way of generating retirement income while avoiding leaving capital behind for those customers that do not have any bequest motives. While retirement investors can achieve income through the cancellation of units by their platform or product provider, the bond ladder approach offers an alternative option to customers.
60. Given that demand for such greater flexibility may emerge in future years as the new retirement market develops further, this issue should be subject to review and discussion as part of the ongoing industry-regulatory dialogue that forms a separate recommendation of the UKFRWG.
61. In addition, we have identified three key areas where the regime could be improved immediately to the benefit of customers and provide recommendations to address them:

### **1. Authorised fund structures do not always allow pension funds to enjoy the tax benefits to which they are entitled**

62. Multi-asset funds will earn interest income which would be exempt of tax in the hands of pension investors but which is subject to corporation tax within the authorised fund. Pension funds operated by life insurance companies can reclaim this tax under existing corporate streaming rules but there is evidence to suggest this is not always done, because of a lack of awareness of the issue. Other pension vehicles, including many retail pension products, are not able to take advantage of corporate streaming and so suffer tax drag when investing in these vehicles. This issue is becoming more acute as the use of multi-asset funds is growing strongly in both the DC accumulation and retirement markets.
63. Pension funds are subject to lower withholding tax rates on overseas dividends than UK authorised funds. However, unless an authorised fund is tax-transparent, pension investors in the fund will not be able to claim the reduced rate.

### Recommendations

64. The UKFRWG is recommending that HMRC should allow deemed deduction for distributions at fund level, which will alleviate the tax drag for multi-asset funds. The Retirement Fund Working Group supports this recommendation as it will also alleviate the technical challenges for pension schemes reclaiming tax in multi-asset funds as well as generally improving the attractiveness and efficiency of multi-asset funds for retirement income.
65. In the meantime, pending a change to the tax rules, the Investment Association should approach the Association of British Insurers to discuss how to ensure that all insurers are reclaiming this tax on behalf of their investors. The primary objective will be to ensure that reclaims are being made but it may be that HMRC will need to be approached for another discussion of how the rules and process could be improved to benefit consumers.
66. Withholding tax issues will probably be best addressed by individual firm decisions on appropriate fund structure. The benefits of reduced withholding tax vary significantly based on the investment strategy and approach of the asset manager.
67. While some asset managers are starting to use tax-transparent funds for defined contribution pension investment, limited investor demand for these vehicles along with the dominance of the life company delivery model are likely to limit the uptake of these vehicles for retirement investors.

**2. Illiquid investments including private market equity and debt, property and infrastructure are well suited to long-term retirement investment.** However, it is not straightforward to include these in UK authorised funds suitable for retail investors.

### Recommendations

68. The RFWG agrees that the proposed Long-Term Asset Fund constitutes an appropriate way forward and pension providers are encouraged to analyse how they would use the LTAF vehicle. In particular, they would need to ensure they are able to include the fund structure in retirement portfolios without adverse impact to their operational approach or capital requirements.

**3. The layering of legal structures within pensions and retirement products means that pension schemes can be subject to different and sometimes conflicting rules**



- 69. The operation of compensation arrangements for pension schemes combining life insurance and investment funds is complex and uncertain. The FSCS has identified the retirement market as a key area of focus in its strategy.
- 70. Disclosure rules, in particular the rules around illustrations and risk warnings, are inconsistent between the regulatory regimes for investment funds and pensions. This has the potential to confuse consumers.

**Recommendations**

- 71. The Investment Association should further engage with the FSCS to identify and resolve the issues here.
- 72. The FCA should over time work to improve disclosure with the objective of reducing or eliminating potential consumer misunderstanding.



### APPENDIX 1: BENEFITS OF USING LIFE INSURANCE VEHICLES FOR DC PROVISION



The use of life assurance vehicles for defined contribution savings has been driven by several considerations:

- Directly invested insured pension funds have tended to be more flexible and tax-efficient than collective investment vehicles. In particular, insured pension funds can receive interest income gross, qualify for low or zero withholding tax rates and are generally exempt from VAT.
- Where insured pension funds invest in authorised vehicles, all income and gains can be accumulated gross of tax in the insured fund removing the need for additional tax reclaims outside of the fund and the administrative complexity these can create.
- Life company funds are generally not subject to concentration limits and so are, at least historically, more flexible for creating funds of funds than collective investment schemes. Larger pension schemes often use this flexibility to create bespoke life funds for their members.
- By “wrapping” 3<sup>rd</sup> party funds as insured pension funds, pension providers can create a common and consistent dealing and settlement cycle for customers even where the underlying funds are trading and settling at different times. This simplifies member record keeping.
- Once monies are received by an insurer, they are not subject to client money rules making it easier to manage dealing activity including same-day switching.
- Pension providers can include their own fees and charges for record keeping and other services in the insured pension fund allowing pricing flexibility and further simplifying administration.

### APPENDIX 2: REINSURANCE RISK IN DC PROVISION

Under the life fund model, pension providers sell life policies to DC investors, who bear the counterparty risk of the provider becoming insolvent and being unable to make good on their promise under the policy.

Where the pension provider uses external life funds from a third party asset manager (itself regulated as a life insurer for the purposes of manufacturing life funds) this relationship is governed by a reinsurance contract between the pension provider and the external asset manager, which allows the pension provider to set up a life fund that mirrors the performance of the external manager's fund. In this instance the provider bears the counterparty risk of any losses that arise from the insolvency of the external manager, unless it has explicitly passed on this risk to policyholders. If this risk was realised, the provider would have to make good any losses suffered by its DC customers invested in the affected manager's fund as a result.

Prudential regulation requires insurers to set aside capital to cover such losses and under Solvency II, such capital requirements have increased. As a result some pension providers have sought to reduce their counterparty risk by moving away from re-insurance contracts with external managers and replacing them with Tax Transparent Funds from those same managers. This has been particularly the case for passive exposures in DC.

### ANNEX 4: DIRECT2FUNDS MODEL TECHNICAL ANALYSIS

1. This annex provides more detailed technical analysis on the Direct2Funds model outlined in Part Two of the main Report.
2. The operational analysis includes the operation of the bank accounts; interaction between the fund and the investor and the different roles and responsibilities of the AFM, fund and Depositary. For ease we have named the account that interacts between the sub funds and the investor as the Issue and Cancellation bank account (IAC) the following describes some of the key points of consideration in operating this model.
  - The nature of the IAC will be different depending on the legal structure of the underlying fund. This is due to the fact an Investment Company with Variable Capital (ICVC) has a legal personality whereas an Authorised Contractual Scheme (ACS) and Authorised Unit Trust (AUT) do not. For an ICVC, the IAC would be in the name of the ICVC Umbrella. For an ACS or AUT, the IAC would be in the name of depositary/trustee re the ACS umbrella/unit trust.
  - Whilst the IAC would normally be expected to operate in respect of all the sub-funds contained in the umbrella structure, i.e. one IAC for all sub-funds, it would be for the AFM to determine the number of IACs operating in the umbrella and which IAC operated for each of the sub-funds. For example, the AFM may determine that it would be preferable to operate a separate IAC in respect of a highly leveraged sub-fund contained in the umbrella.
  - The IAC would be operated by the AFM under the oversight of the Depositary / Trustee.
  - The AFM may use the services of a third party to perform the daily operational activities.
  - The Direct2Fund model seeks to preserve the responsibilities of the AFM in all other aspects. The AFM would remain responsible for AML, managing cancellation rights processes, issuing contract notes, reporting and all general communications with investors. The AFM would remain the primary interface with the investors.
  - Investor subscriptions would be received directly into the IAC and payments would be made to investors directly from the IAC.
  - Cash transfers would be made from the IAC to the sub-fund accounts in respect of the value of the shares issued in the sub-funds and would be received to the IAC from the sub-funds in respect of shares cancelled in the sub-funds. These payments and receipts would be made on the contractual settlement date.
  - As the IAC is a scheme asset it would be included in the financial statements of the fund vehicle.

### REGULATORY IMPLICATIONS

3. The Working Group has undertaken an analysis of the current legal and regulatory framework for fund dealing, focusing on the requirements of COLL and the OEIC Regulations and how these would apply to a Direct2Fund model.
4. For ICVCs, both COLL and the OEIC Regulations make provision for the AFM to act as an agent in the context of fund dealing transactions, with the fund being the principal to the trade. The position of ACS and AUT is more complex, due to the lack of legal personality of the fund vehicle, even though, as with ICVCs, direct dealing is still contemplated in COLL. In some areas the provisions in COLL for fund dealing reflect the historic business practice of AFMs dealing as principal with investors. The Working Group believes it will be important to clarify the application of certain rules and possibly modify some with appropriate references to a Direct2Fund model.

### OEICS – KEY CONSIDERATIONS – COLL

5. Although in many places COLL appears to accommodate both principal dealing and a Direct2Fund model, some provisions in COLL may need to be modified or clarified to enable the Direct2Fund model to operate properly:

#### **The AFM's obligation to effect sales and redemptions on each dealing day as principal in accordance with the Prospectus (COLL 6.2.16R (2)/COLL 8.5.11R).**

6. It will need to be made clear that this rule applies only where principal dealing is the AFM's approach, as set out in the Prospectus. An alternative provision could be included for AFMs operating a Direct2Fund model, for example, an obligation on the AFM on behalf of the fund to arrange for the issue or cancellation of shares each dealing day.

#### **The AFM's obligations to effect redemptions and to pay the proceeds of a redemption to the investor (COLL 6.2.16R (3)-(5))**

7. Again, these rules are only appropriate for a principal dealing model. An alternative could be included for the Direct2Fund approach such as the AFM arranging for the fund to effect the cancellation of the shares and, under the oversight of the Depositary, pay from the IAC the proceeds to the investor. There may be a need for an additional obligation on the AFM to ensure that the fund has sufficient cash available to meet cancellation payments and if this is not the case for the AFM to compensate the fund for interest costs incurred should the fund have to borrow to make the cancellation payment – COLL 6.2.14 R (2) may need to be modified for the Direct2Fund model.

#### **The AFM's obligations to arrange for and make payment to the fund for shares issued**

8. The "creation payment" should be made no later than the 4th business day following the issue of shares in accordance with COLL 6.2.13R (1) and (2). There is a similar but less prescriptive rule for QIS funds in COLL 8.5.10R(3). Under the Direct2Fund model, the investor will make the payment for shares purchased directly to the fund, so this rule should be modified for the Direct2Fund model.

#### **The ACD's obligation to reimburse the fund for lost interest in the event of a delay or failure to make the creation payment (COLL 6.2.13R (3))**

9. Whilst logically this obligation should also fall away, the Working Group concluded that to ensure no loss of investor protection for existing investors it would be appropriate for the AFM to retain this responsibility in the event that an investor failed to pay for their shares on the settlement date. The AFM would then decide what action to take in relation to the defaulting investor e.g. exercising powers as agent for the fund to cancel the trade or to seek compensation from the investor for the interest costs. The language of COLL 6.2.13R(3) would need some modification to reflect this and it may be appropriate to add some guidance around the steps the AFM may wish to consider taking in these circumstances.

### **Control by the depositary over the scheme property (COLL 6.6.12)**

10. The IAC will be scheme property. For an ICVC, the IAC will be in the name of the fund so it may be necessary to modify COLL 6.6.12 to ensure the Depositary can fulfil its safekeeping obligation in relation to the account through its monitoring and oversight activities. (This appears to have been contemplated under COLL 6.6.B.17)

### **Segregated Liability Principle (COLL 3.2.6R 22A)**

11. An ICVC Instrument must include a statement that the assets of a sub-fund belong exclusively to that sub-fund and shall not be used to discharge directly or indirectly the liabilities of, or claims against, any other person or body, including the umbrella or any other sub-fund, and shall not be available for any such purpose. This reflects the segregated liability principle in the OEIC Regulations. The operation of the IAC is intended to be consistent with this.

## OEICS – KEY CONSIDERATIONS- OEIC REGULATIONS

12. Our analysis has identified certain aspects of the OEIC Regulations which should be reviewed further to ascertain whether there is sufficient flexibility for the FCA to adopt further rules within the framework of the OEIC Regulations or whether additional changes to the OEIC Regulations will be required. We have noted there are no substantive provisions in the OEIC Regulations (and only limited provisions in COLL) relating to the procedures to be followed in issuing and cancelling shares. The OEIC Regulations contain some provisions in relation to share transfers in Schedule 4 but it is not entirely clear whether or how these can be applied to a Direct2Fund model.

### **Protected cell regime**

13. The Direct2Fund model envisages a single IAC at umbrella level opened in the name of the ICVC for receipt of subscription and redemption monies. The AFM (or the transfer agent as delegate of the AFM) would record each transaction and the associated cash payments relating to it at investor and sub-fund level. Monies would flow between the IAC and the custody cash accounts for the relevant sub-funds. The AFM would ensure through its record keeping and operational processes that cash received for shares in one sub-fund is only paid out to the custody account of that sub-fund i.e. it would not be possible for cash due to one sub-fund to be paid over to another sub-fund.
14. Each payment received would be referable to the relevant investor and the process would ensure that one investor's payment could not be used to settle another's

transaction. Similarly, cash would be received from a sub-fund into the IAC in order to make a redemption payment in relation to shares in that sub-fund and it would not be possible to make this payment from cash received from another sub-fund. Again, each payment will be referable to the relevant investors' transactions and the processes will ensure that cash received into the IAC for one investor could not be used to fund the redemption payment to another investor. The Depositary would oversee the AFM in this respect. The processes would be designed to be consistent with the segregated liability principle set out in Regulation 11A. Advice is to be sought on the implications of the insolvency of one of the sub-funds.

### ACS/AUT – KEY CONSIDERATIONS

15. The points raised above in relation to COLL also apply to ACS/AUT.
16. ACS/AUT is more complex because the fund vehicle does not have its own legal personality: The investor has to contract with either the manager (as is the current model) or the Trustee/Depositary acting in its capacity as such for the fund.
17. For the Direct2Fund model the IAC for an ACS/AUT would be Scheme Property and would be in the name of the Trustee/Depositary. Consideration would be need to be given as to what liability might arise for the Trustee/Depositary should there be a loss in the account.
18. The investor would be buying and selling units directly with the Trustee/Depositary who would be responsible for the issue and cancellation of the units. However, the Trustee/Depositary's responsibilities for managing the investor relationship would be limited. It is envisaged that a new framework of rules would be adopted whereby COLL specifically prescribed what the Trustee/Depositary would be responsible for (essentially issuing or cancelling the units) and what the AFM would be responsible for e.g. investor eligibility checking, anti-money laundering procedures, managing cancellation rights processes, issuing contract notes and reporting and all general communications with investors. The AFM would still therefore be the primary interface with the investors.
19. Trustee/Depositaries would require confirmation from the FCA that these activities should be considered to be within its role as acting as a Trustee/Depositary of a UCITS or an AIF and that undertaking this role would not require any additional regulatory Part IV permissions.

### ISAS

20. ISA Regulations require ISA subscriptions to be made to an ISA Manager and therefore ISA subscriptions cannot go direct to the fund. If ISA subscriptions have to continue to go to the ISA Manager, these would be treated as client money which means the investor loses the benefits of the reduced risks under the Direct2Fund model and the AFM would still have to meet the costs of CASS. Various solutions to this have been considered including enabling the ICVC to act as the ISA Manager or only permitting ISA subscriptions of assets rather than cash. However, these possible solutions bring their own challenges and further thought is required on this with the assistance of HMRC.

### **TITLE TRANSFER**

21. As part of the discussions on a Direct2Fund model, the Working Group has considered the question of "When does an investor get ownership of shares or units?" There does not appear to be a generally accepted industry consensus on this point and the legal and regulatory framework does not, at present, provide absolute certainty on this issue.
22. If COLL is being modified to accommodate Direct2Fund dealing, it may be appropriate to give further consideration to this issue and take the opportunity

## ANNEX 5: RESOLVING TAX INEFFICIENCIES AND REDUCING COMPLEXITY

1. This annex provides more detailed technical analysis on the tax recommendations made in Part Two.

### REVIEW OF UK FUNDS TAX REGIME

#### TAX EFFICIENCY OF UK FUNDS

2. Funds are tax efficient conduit for investors, offering investors the benefits of collective investments and risk spreading while preserving, so far as possible, the tax treatment that an investor would have if investing directly in the underlying assets. This concept of tax neutrality ensures that there is no double taxation. Any tax drag at the fund level undermines the tax neutrality principle and makes funds less attractive for investors.
3. Most UK funds generally do not pay taxes due to application of UK dividend tax exemption on income from equity investments at the fund level or the deduction for interest distributions by bond funds. However balanced or multi-asset funds that do not fall within the definition of a bond fund suffer tax on income from derivatives and on any interest income, without a deduction for distribution of such income, which results in a tax drag at the fund level.
4. The existing Tax Elected Funds (TEF) regime does not provide a solution to this problem particularly for retail and tax exempt investors. At a practical level, the TEF regime does not succeed as evidenced by the fact that there are hardly any TEFs in the market. Anecdotally the complexities of developing the necessary solution to apply the TEF regime effectively outweigh the potential benefits. The practicalities of handling two distributions for a single fund for product providers, and platforms in particular, have meant that TEFs have seen little take-up. Our research with providers suggests that this is likely to remain the case for the foreseeable future.
5. We have illustrated this by way of following simplified examples:

#### Balanced fund

	Income earned	Tax position
Dividend income	100	Nil*
Interest income	40	40
Less: management expenses		(20)
Taxable Income		<b>20</b>
UK CT on above @20%		£4



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### Equity funds holding derivatives

Dividend income on equities	100	Nil*
Dividend Income on equity derivatives	50	50
Less: management expenses		(20)
Taxable Income		<b>30</b>
UK CT on above @20%		£6

\* assumed exempt as per UK dividend exemption rules<sup>30</sup>.

6. A limited sample of 14 UK balanced funds of 4 fund houses with total assets of £17.7bn suffered total tax of £25.9m (15 basis points) in the most recent accounting period, with some as high as 74 basis points for certain balanced strategies. The wider universe (excluding fund of funds) has total assets of £129bn.<sup>31</sup> Extrapolating this to the wider universe assuming a 15 basis point tax leakage would mean total tax leakage of circa £188.8m.
7. Currently streaming of distribution exists only for corporate investors who are able to claim credit for the taxes paid at the fund level. However, no such rules exist for retail investors or exempt investors such as pension funds (not linked to insurance companies) or ISAs which means that the tax suffered at the fund level becomes a real cost to these investors, not in line with the principle of fiscal neutrality.
8. In the Autumn Statement 2016<sup>32</sup>, it was proposed that the government will modernise the rules on the taxation of dividend distributions to corporate investors in a way which allows exempt investors, such as pension funds, to obtain credit for tax paid by authorised investment funds and will publish proposals in draft secondary legislation in early 2017. However, no further legislation was introduced.
9. The current tax regime of UK authorised funds is predicated on the taxation of UK investors taking into account the difference in the tax treatment of dividend and interest income. With the introduction of the tax-free allowance for savings interest and dividends and the abolition of dividend tax credits, the tax framework of UK investors has evolved reducing the need for such differentiation.
10. Given this and the increased investment in funds through ISAs and pensions, raises the question as to the need for the TEF regime to differentiate between interest and dividend returns.

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<sup>30</sup> Part 9A of CTA 2009

<sup>31</sup> Source: IA calculations and IA funds data from the mixed assets sectors as at July 2018.

<sup>32</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/571559/autumn\\_statement\\_2016\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/571559/autumn_statement_2016_web.pdf)

## Annex 5 Resolving Tax Inefficiencies and Reducing Complexity

11. Additionally, the existing rules create a mismatch with offshore funds in that offshore funds are not subject to the streaming requirements and therefore there is asymmetry between taxation of distributions from onshore and offshore funds.

### IMPACT OF UK FUND TAX INEFFICIENCIES

12. **Higher tax costs for investors:** as detailed above the tax at fund level is not recoverable by retail or exempt investors, which results in lower returns for such savers. Any tax drag at the fund level undermines the tax neutrality principle and makes funds less attractive for investors.
13. **Perception:** The current tax rules therefore create inherent tax inefficiency of such products. While such tax inefficiency only applies in case of specific types of funds with most equity funds and bond funds not suffering any UK taxes, it fuels to the perception that UK funds are not tax efficient unlike the offshore funds based in other popular fund locations.
14. **Competitiveness:** All these factors have a disproportionate and unfair tax impact on UK retail and exempt investors by imposing irrecoverable additional costs on these investors. Irish and Luxembourg funds are tax exempt and do not suffer comparable leakage. Therefore, offshore fund vehicles become more attractive for certain categories of domestic investors, as well as foreign investors. This drives fund managers to offshore solutions with consequential impact on jobs and the wider support economy.

This is reflected in the data in Table 1.

**Table 1: Net AUM of UCITS and AIFS domiciled in the UK in comparison to Luxembourg and Ireland<sup>33</sup>**

Country	Net Assets (€bn)
	2017
UK	1,647
Luxembourg	4,160
Ireland	2,396

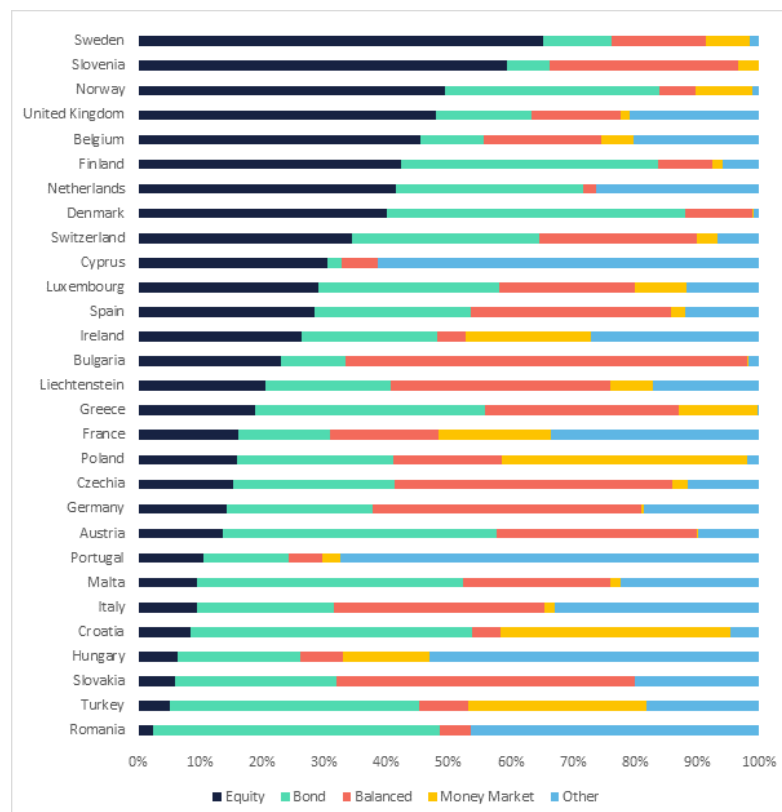
15. **Impact on development of new products:** This problem would only be accentuated with the shift in product demand towards more solutions-focused strategies (including liability-driven investment) and alternative asset classes as discussed in Part One of the main Report. The UK tax regime has been designed primarily for single strategy funds and as such is unsuitable for solution-oriented products such as multi-asset funds.
16. The effect of these complexities is likely to be one factor influencing the relatively low asset base of UK balanced funds as compared to other European jurisdictions (see

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<sup>33</sup> Source: EFAMA

Figure 1).<sup>34</sup> However, it should also be recognised that the high equity exposure of UK fund investors reflects significant cultural features, seen in parts of Scandinavia as well. It stands in sharp contrast to much of the continental European market.

**Figure 1: Breakdown of European funds under management by fund type**



### ALTERNATIVE SOLUTIONS

17. Alternative regimes therefore need to be considered to deal with these tax inefficiencies in order to provide a stable and consistent fund tax framework.
18. In the past, enhancements have focussed either on specific parts of the existing regime (for example investment transactions whitelist, dividend exemption, income tax withholding) or on special regimes (example Tax Elected Funds, Fund Investing in Non-reporting Offshore Funds, Qualified Investor Scheme and Property Authorised Investment Funds). As a result the current regime is complex and unwieldy. This adds to the perception that UK funds are not suited for international distribution. It is for this reason that we believe any reform has to be holistic in nature.
19. While considering the tax regime for any UK fund vehicles, a review of the shape and the coherence of the UK tax treatment of existing, as well as new funds needs to be carried out to enhance the attractiveness of the UK as a location for fund domicile. The review could involve various alternatives such as simplifying the existing special tax regime for UK funds or introducing a new fund tax regime with the option to convert

<sup>34</sup> Source: EFAMA

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existing funds to the new regime, with the ambition that such a fund would have no tax filing requirements.

20. The ability of UK funds to access the vast network of tax treaties that UK has negotiated with over 130 countries is a significant benefit afforded to UK funds as a result of the UK tax treatment and should be recognised and maintained.
21. Additionally while looking at new funds, attractiveness for both domestic and foreign investors should be considered.
22. The following possible alternative , which is not an exhaustive list, could be explored in this regard:
  - **Alternative A: Possible option for tax exemption for UK funds** which can alleviate the tax drag but needs to be balanced with the loss of any treaty benefits.
  - **Alternative B: Reduction in tax rate of UK funds** to 1% such that tax leakage at fund level can be fully alleviated, while maintaining treaty access.
  - **Alternative C: Deemed deduction for distributions at fund level** which can alleviate the tax drag at fund level and make UK funds more comparable to offshore funds.
  - **Alternative D: Revisit the TEF requirements with simpler reporting mechanism**
  - **Alternative E: Extension of corporate streaming to individuals.** This will be complex and involve a reclaim process at the investor level.
23. There are pros and cons in all of these alternatives which are considered below:

	<b>Option A</b>	<b>Option B</b>	<b>Option C</b>	<b>Option D</b>	<b>Option E</b>
<b>Complexity</b>	Simple	Simple	Simple	Complex	Most complex
<b>Revenue Neutral</b>	No*	No*	No*	Yes	Yes
<b>Requires additional HMRC and industry resources</b>	No	No	No	Yes	Yes
<b>Additional requirements for funds to report</b>	No	No	No	Yes	Yes
<b>Additional filing requirements for investors</b>	No	No	No	Yes	Yes
<b>Reclaim required by investors</b>	No	No	No	No	Yes
<b>Comparability of UK tax</b>	Yes	Yes	Yes	Additional requirement	Additional requirement

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<b>treatment for offshore funds</b>				on UK funds to stream the distributions	on UK funds stream the distribution and for investors to reclaim the tax
<b>Treaty access</b>	Partial	Yes	Yes	Yes	Yes

*\* Even though the option is not revenue neutral, all things being equal the tax should be recoverable by investors (irrespective of investor type) to achieve the full tax neutrality.*

### THE 60% TEST

24. An additional complication for UK authorised funds is the need for constant monitoring of the qualifying investment test or the 60% test (applying to interest bearing assets) throughout the year under the Authorised Investment Funds (Tax) Regulations 2006 ("the AIF regulations) for a fund to be able to make interest distributions.
25. The AIF regulations require the 60% test to be met throughout the distribution period for distribution to be considered as interest distribution. This is a cliff-edge test requiring constant monitoring. In case of a mixed asset or balanced fund, the daily fluctuations in investment holding could therefore mean that the fund may have a different status for each distribution period. This gives result to various issues including fund pricing.
26. Given the challenges in the monitoring of this test, many balanced funds are treated as equity funds and therefore become less tax efficient for investors for reasons set out above.
27. **Possible solutions could include availability of advance clearance procedures or a less frequent monitoring requirement (say every 3 years) of the 60% test with a Genuine Diversity of Ownership (GDO) requirement to limit avoidance.**

### VALUE ADDED TAX (VAT)

28. A competitive VAT regime that allows businesses to effectively manage their VAT costs is a vital consideration. VAT can be a significant cost to UK-based fund managers when managing UK funds, disproportionately impacting business decisions.
29. More consistent and comprehensive application of the current VAT exemption for fund management would be beneficial but, fundamentally, **a competitive UK VAT regime for existing and new funds is critical for their success as a suitable alternative to offshore funds.**
30. Under the current VAT regime, a UK investment manager managing an offshore fund can benefit from full VAT recovery while no VAT is charged on the fund itself. In contrast, the management of UK funds is either exempt from VAT (if they are qualifying funds), or is subject to VAT (otherwise). Where the fund is exempt from VAT, the input tax recovery of the investment manager is restricted. For a UK fund structure to be commercially viable, the current VAT treatment available on UK management of offshore funds needs to be extended to management of comparable UK vehicles. This can be

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done, for example, by applying a zero rate of UK VAT to the management of such funds. We note, however, that under current EU VAT law it would not be possible for such zero-rating provisions to be introduced in the UK.

31. Funds offer investors many advantages through collective investments over direct investments including access to professional investment managers, diversification and risk spreading, economies of scale, ease of access to certain investments, lower transactions costs etc. The management of collective investments entails the outsourcing of certain functions necessary for such funds to operate to specialised service providers. The exemption for fund management services provided to special investment funds [referred to as the 'SIF VAT exemption'] under Article 135(1)(g) of the Principal VAT Directive aims to ensure tax neutrality between direct investments (whereby investors do not incur VAT) and indirect or collective investments. A clearly defined interpretation of special investment funds in the UK allows the UK to be a good place for international provision of management and management adjacent services, whilst providing scope for a UK fund range which does not suffer VAT drag.
32. The definition of what constitutes 'management' has been subject to significant amount of litigation and the recent CJEU decisions have provided more guidance on how it should be interpreted particularly in the context of outsourced functions. However, there is a need for HMRC to give the proper effect to such case law so that for those supply chains that ultimately relate to a special investment fund, no additional VAT cost is suffered purely for the reason that certain functions necessary for the operation of the funds are outsourced. HMRC's position often remains that such outsourced services are taxed, in contradiction to court decisions in *GfBk* (C-275/11), *Blackrock* [2018] UKUT 415, *Abbey National*(C-169/04) etc. Latest examples (which may well lead to even further litigation) include:
  - Clarity on the SIF VAT exemption for research services paid under the MiFID II Directive: A significant current issue for the industry is the availability of the SIF VAT exemption for research services paid under the MiFID II Directive. HMRC's current position has effectively rendered its guidance unworkable in practice and inconsistent with the aforementioned jurisprudence. This position has the result that investment managers are facing significantly increased costs as a consequence of a regulatory change. Businesses urgently need a fair and practical solution as to how the SIF VAT exemption is to be applied to research services.

This matter is of great significance to the investment management industry and the wider eco-system. The lack of a VAT exemption for the supplies in question, based on the position that HMRC articulate, could directly and negatively impact location decisions, as investment managers review their operating models.

- Similarly, the application of the SIF VAT exemption under the principles of the CJEU case in *GfBk* (C-275/11) and more recently the UK Upper Tier Tribunal's decision in *BlackRock* [2018] UKUT 415 to other services used by asset managers and the range of funds they manage needs to be considered urgently. This is important in the context of the competitiveness of UK compared to other overseas jurisdictions, particularly given other pressures on location choice at the present time.

### WITHHOLDING TAXES AND ACCESS TO TAX TREATIES

33. Increasingly, the advantage that UK funds hold over funds domiciled offshore on tax treaty access is being eroded by overseas authorities who place technical or practical barriers that prevent treaty benefits from being obtained. More significantly, recent tax treaties agreed between the UK and overseas tax authorities (for example US-UK tax treaty) are not conducive to a UK fund being marketed internationally because of limitation of benefits clause. This clause broadly requires over 50% UK ownership of a fund in order to access the tax treaty.
34. Additionally, Memorandum of Understandings (MOUs) agreed between the UK and overseas tax authorities (for example the UK-Swiss MOU) limit the withholding tax relief of a fund to the proportion of UK resident beneficial owners in that fund. The data requirement and process to prove such information can be particularly onerous resulting in delay or non-availability of withholding tax relief to UK funds.
35. Such tax treaties and MOUs have a significant adverse impact on UK funds and their ability to continue to claim treaty benefits. It is important to renegotiate significant tax treaties and MOUs to recognise the international nature of funds and simplifying treaty access procedures.
36. We have included below two examples of countries where treaty access for UK funds has been problematic in recent times:
- **Switzerland.** Traditionally, UK Funds were able to access reduced rate of withholding taxes on dividends received on their Swiss investments under the UK/Swiss tax treaty. Over the last few years, this reduced rate has not been available due to the Swiss authorities asking for detailed information including names and addresses of all investors in the fund to prove the percentage of UK investors in the fund. This onerous information has resulted in treaty claims being denied to UK funds. This onerous request for detailed information from funds has resulted from an MOU regarding investment vehicles signed between UK and the Switzerland in 2008. While the IA has been engaged in discussions with the Swiss Tax Authorities and HMRC over the last few years to agree a practical solution to this problem, it has become apparent that any mutually acceptable solution is likely to be expensive, time consuming and not necessarily successful in all cases.
  - **South Korea.** There are onerous requirements in relation to overseas investment vehicles (OIVs) under the tax laws in Korea for claiming access to treaty benefits in Korea. An OIV is required to submit a list of all beneficial owners of the Korean source income in a specified format as well as require each beneficial owner to complete and submit a specified form to the OIV. This makes it difficult and time consuming for UK funds to successfully obtain treaty benefits in Korea.
37. **Brexit.** This will become even more important after Brexit if UK funds can no longer access the preferential withholding tax rates that they are currently able to benefit from due to their EU fund status. Lower withholding tax rates or exemptions on investments in EU jurisdictions apply to EU/EEA investment funds and pension funds as a result of their EU fund status. UK funds therefore are able to access these preferential rates. In

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the case of a no deal Brexit, or any deal which would cause funds to lose their EU status, UK funds would lose access to certain preferential EU WHT rates currently obtained from EU jurisdictions. Alternatively it might become necessary to follow a more complex process for retaining some of the benefits as they apply to any third country (non EU) funds or for claiming relief under the relevant treaty. An increase in irrecoverable WHT costs will have a direct impact on a fund's income yield.

Territories where this is likely to be an issue for funds include Italy, France, Spain, Norway, Sweden, Czech Republic, Greece and Slovenia.

### **Recommendations:**

- **An explicit objective for HMRC to maintain protection for UK funds, where tax authorities seek to undermine existing treaty rights.**
- **An explicit mandate to HMRC to engage positively with overseas jurisdictions with a view to preserving and improving treaty rights particularly where the treaty access issues are likely to arise post Brexit in territories where UK funds have previously not had to rely on tax treaties.**
- **A requirement for all future negotiations to consider clear and specific provisions for collective investment vehicles and pension funds (including life companies with solely pensions business) as well as specifically recognise the transparency of the UK ACS.**



## GLOSSARY

ACS	Authorised Contractual Scheme	Collective investment schemes under the UK regime introduced by the Collective Investment in Transferable Securities (Contractual Scheme) Regulations in 2013. It the ability to preserve the tax status of the investor in relation to the investments made by the fund.
Active fund strategy		Strategy by which fund manager makes active decisions about the investment strategy.
AIF	Alternative investment fund	Collective investment scheme that is not subject to the UCITS regime.
Bond ladders		Portfolio of bonds with different maturity dates in order to minimize interest-rate risk, increase liquidity and diversify credit risk.
CJEU	The Court of Justice of the European Union (CJEU)	EU institution ensuring consistent application of and respect for European law
DB pension schemes	Defined Benefit pension schemes	Pension scheme where the amount paid on retirement is based on individual's earnings history, tenure of service and age.
DC pension schemes	Defined Contribution (DC) schemes	Pension scheme where the amount paid on retirement depends directly on individual investment returns (after fees) in combination with level of contribution
ELTIF	European Long-Term Investment Fund	Collective investment schemes authorised under the ELTIF regulation which qualify as Alternative Investment Funds. It benefits from a European passport and is designed for investment in illiquid asset classes
ETF	Exchange-Traded Fund	Open-ended, collective investment scheme which tracks an underlying index.
ICVC	Investment Company with Variable Capital	Open-ended collective investment schemes incorporated under the Open-Ended Investment Companies Regulations of the United Kingdom.
Illiquid asset class		Assets that cannot easily be sold or exchanged for cash.
IMS I	The Investment Management Strategy I	Report published on 6 December 2013 by the HM Treasury which sets out a comprehensive strategy that will inform government policy in the coming years with regard with the UK asset management industry in the long term.

IMS II	The Investment Management Strategy II	Report published on 6 December by the HM Treasury as an update to IMS I which sets out a comprehensive strategy that will inform government policy in the coming years with regard to the UK asset management industry in the long term.
Index fund strategy		Strategy by which a fund is managed to replicate the holdings and performance of a designated index that is by investing in the same securities that compose the index.
Liability Driven Investment		Strategy that is designed to help schemes specifically manage the risks associated with current and future liabilities. This can also exist as a fund serving multiple customers.
Low yield environment		Environment where low global interest rates result in low returns
NURS	Non-UCITS Retail Scheme	UK regulatory framework for an authorised investment vehicle which can be marketed to retail clients within the UK and do not comply with the requirements of the UCITS Directive. NURS' have restricted investment powers and limits which ensure high levels of investor protection.
Passive fund strategy		Strategy by which fund manager tracks a market-weighted index or portfolio.
Patient Capital		Long term investment with different definitions. Government using it currently in association with funding companies at a specific stage of development.
Pension Freedoms		Changes introduced by the Government in April 2015 where people who are 55 or over, with a DC pension plan, can access the money they have accumulated as they choose.
Pooled vehicle		Collective investment scheme which combines into a single investment fund, the funds from numerous individual investors.
Private equity		Private equity is an alternative investment class and consists of capital that is not listed on a public exchange.
Private markets		Private markets refer to investments not traded on a public exchange or market.

QIS	Qualified investor schemes.	UK regulatory framework for an authorised investment vehicle that can only be marketed to professional clients and retail clients who are deemed "sophisticated investors". A QIS has wider investment and borrowing powers than other authorised investment vehicle such as NURs and UCITS.
SIF	Specialised investment funds	Collective investment schemes regulated by Luxembourg Part II of the Law of 17 December 2010 on undertakings for collective investment it is characterised by greater flexibility with regard to the investment policy and a lighter touch regulatory regime.
Tax Leakage		Loss of revenue due to the difference between the tax which could be paid and the tax actually collected.
UCITS	Undertakings for Collective Investments in Transferable Securities.	European regulatory framework for an investment vehicle that can be marketed across the European Union while maintaining high levels of investor protection. To ensure the later UCITS have restricted investment powers and limits.