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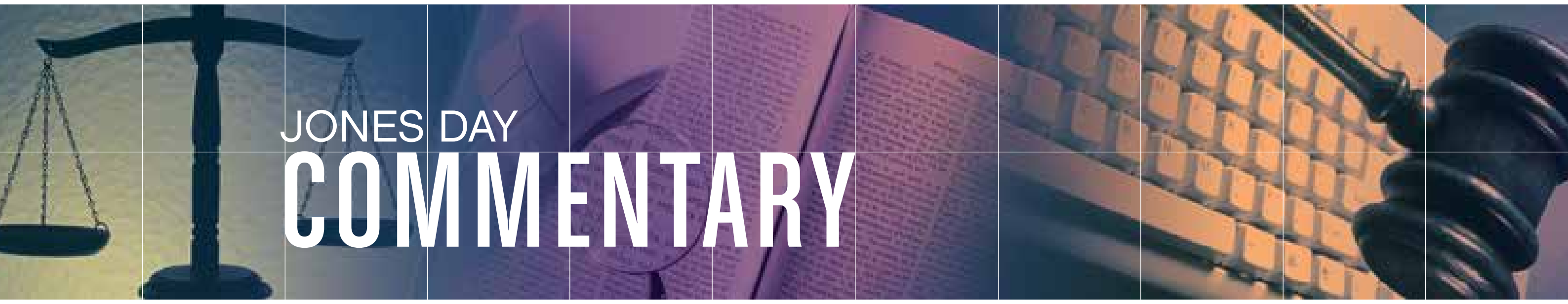

TAX TRANSPARENT FUNDS IN THE UK

In January 2012, HM Treasury proposed the introduction of contractual schemes for collective investment. The main objective of introducing contractual schemes was stated as being to ensure that the UK is able to compete for a share of the market in European pooled funds following the implementation of the Undertakings for Collective Investment in Transferable Securities ("UCITS") IV Directive in July 2011, which allows UCITS funds to establish master-feeder arrangements.

Following on from the initial consultation period, HM Treasury published several drafts of the Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2012/13 (the "Regulations") together with drafts of three complementary tax Regulations.[1]

On 31 January 2013, HM Treasury published a further draft of the Regulations and an accompanying update. This iteration of the Regulations included amendments to take account of policy development in response to the feedback raised during the consultation process. The main changes relate to the transfer of units and conditions for investment by retail investors. Other changes reflect discussion about the application of partnership and insolvency law.

In addition, the Financial Services Authority (now replaced by the Financial Conduct Authority ("FCA") and the Prudential Regulation Authority) issued a consultation paper in February (CP13/5) addressing the proposals for tax transparent funds and the new rules (to be included in the FCA's Collective Investment Schemes Handbook ("COLL")) which will enable contractual schemes to be authorised and regulated. The Tax Regulations were also updated.

On 12 June, the Regulations (SI 2013/1388) were published on legislation.gov.uk, together with an explanatory memorandum (a previous version of which had been published on 27 March).

The explanatory memorandum notes that the Regulations make provision for the FCA to make rules about the formation and operation of

1 The Collective Investment Schemes (Tax Transparent Funds, Exchanges, Mergers and Schemes of Reconstruction) Regulations 2013; The Stamp Duty and Stamp Duty Reserve Tax (Collective Investment Schemes) (Exemptions) Regulations 2013; and The Value Added Tax (Finance) Order 2013 (together, the "Tax Regulations").

authorised contractual schemes. Once the FCA has formally made the required rules, it will publish a policy statement and guidance on its web site.

The Regulations were made on 5 June and came into force on 6 June. The Tax Regulations were finalised and made on 7 June. The Collective Investment Schemes (Tax Transparent Funds, Exchanges, Mergers and Schemes of Reconstruction) Regulations 2013 came into force on 8 June, and The Stamp Duty and Stamp Duty Reserve Tax (Collective Investment Schemes) (Exemptions) Regulations 2013 and The Value Added Tax (Finance) Order 2013 came into force on 28 June.

This brief *Commentary* sets out the key features of contractual schemes for collective investment.

EXECUTIVE SUMMARY

Prior to the Regulations coming into force, the previous regulatory regime in the UK allowed the FCA to authorise only two different legal forms of collective investment scheme. These two legal forms are: (i) an authorised unit trust ("AUT"); and (ii) an open-ended investment company ("OEIC"), neither of which is tax transparent.

Now there are two additional new vehicles available: co-ownership schemes and limited partnership schemes (as described further below) which are transparent for tax purposes and thus allow tax to be paid only by the investor, rather than by both the investor and the vehicle itself. Such a scheme may be established as an UCITS, a non-UCITS retail scheme ("NURS") or a qualified investor scheme ("QIS"). The regulatory regime for a QIS is less prescriptive than those which apply to UCITS and NURS.

Broadly, the Tax Regulations provide that: (i) investors in a tax transparent fund vehicle will be treated for chargeable gains purposes as owning an interest in the fund, rather than in the underlying assets, meaning a gain should arise only on a disposal of an interest in the fund, not each time the fund itself disposes of an asset; (ii) certain transfers of interests in funds, such as the transfer of interests to a depositary or transfers between depositaries under the same scheme, are exempt from stamp duty (and stamp duty reserve tax)[2]; and (iii) the management of authorised schemes shall be VAT exempt.

HM Treasury, in its March publication "The UK investment management strategy", heralded the introduction of such vehicles as "a significant step in supporting the UK investment management industry and providing the necessary framework to ensure that the UK can be the location of choice for international fund domicile".

HM Treasury anticipates that the schemes will be attractive to managers looking to pool assets from funds across Europe, and potentially more widely, using arrangements permitted by the UCITS IV Directive. In such a structure a UK contractual scheme would form a "master fund" into which UCITS funds from across Europe could combine their assets. According to HM Treasury, "this will create economies of scale, allow industry to reduce costs and increase returns to investors".

Indeed, HM Treasury believes the schemes will be particularly suited to certain tax-exempt institutional investors, such as pensions companies, which may be able to take advantage of their transparent nature to secure more attractive rates of foreign withholding tax than might be the case when investing in an opaque fund.

For completeness, it should be noted that the Alternative Investment Fund Managers Directive ("AIFMD") will be implemented on 22 July. The AIFMD applies to any legal person whose regular business is managing (i.e. providing portfolio management and risk management services to) any collective investment scheme which is not an UCITS and may therefore apply to certain authorised contractual schemes.[3]

2 Note however that, depending on specific circumstances, stamp duty and stamp duty reserve tax may still arise on the transfer of interests within a tax transparent fund or a variation to an investor's interest in the fund and so specific tax advice should always be sought.

3 Please see Jones Day's *Commentary* on the AIFMD issued in April 2013 and available via our web site (http://www.jonesday.com/alternative__investment__fund__managers__directive/) for further information on the AIFMD.

TYPES OF AUTHORISED CONTRACTUAL SCHEMES

As mentioned above, the following two types of regulated, tax transparent fund vehicles will be introduced under the Regulations: (i) co-ownership schemes; and (ii) limited partnership schemes. Collectively, these vehicles are referred to as “authorised contractual schemes” (“ACS”).

In a co-ownership scheme, the property is beneficially owned by the participants as tenants in common. The scheme has no legal personality distinct from the investors. Its assets are managed on behalf of the participants by an operator, while a depositary holds legal title as custodian (both the operator and the depositary requiring appropriate authorisation).

The deed that constitutes a co-ownership scheme is made between the operator and the depositary. The scheme must be authorised before participants are able to acquire any interests in it. Participants will acquire rights by subscribing for units rather than by executing the deed. The deed will authorise the operator to acquire, manage and dispose of property for the purposes of the scheme and to enter into contracts for, or in connection with, the acquisition or disposal of property. The depositary will hold legal title to the assets and, together with the operator, will accept fiduciary duties which are compatible with co-ownership of the assets by the participants.

A limited partnership scheme is a limited partnership under the Limited Partnerships Act 1907. The limited partnership scheme will be formed by deed and will have only one general partner who will be responsible for the operation of the scheme. The scheme property will be held by the depositary. The limited partners will be participants in the scheme and units will be issued in exchange for contributions to the partnership.

HM Treasury has stated that, in the interests of clarity of management responsibility, it is important to ensure that a single person authorised under the Financial Services and Markets Act 2000 (“FSMA”) to operate a collective investment scheme should have the functions and liabilities of the operator and general partner. HM Treasury has stated that the general partner may delegate management functions but that the appointment of such a delegate would not affect the responsibilities of the general partner in respect of the scheme (including its regulatory responsibilities under FSMA).

This suggests that the general partner will need to be authorised under FSMA regardless of whether such a delegate is in place, which is not always the case with limited partnerships. If a delegate is appointed, it will need to be authorised in respect of its management activities. Having two authorised persons within a structure may call the value of delegating into question, albeit that the general partner’s unlimited liability will be likely to remain an important consideration. Furthermore, it is not clear yet how the flow of fees would work in such a scenario. For example, there is no guidance as to whether the fees for a delegate would have to flow from the partnership through the general partner to the delegate (whether or not the delegate and the general partner are within the same group). As noted above, it will be important to consider any ACS structure from an AIFMD perspective and, based on the above, either the general partner or the management delegate could fall to be the alternative investment fund manager to whom the AIFMD would apply.

During the consultation process, concern was expressed about the problems arising from the discontinuity in a limited partnership that would result from a change of limited partners therein. To deal with this, the Regulations modify the general law of partnerships to provide for the special characteristics of a limited partnership set up to operate as an authorised vehicle for open-ended collective investment.

These special characteristics include the right of a limited partner to draw out its contribution without dissolving the partnership, and the exercise of rights conferred on participants by FCA rules. In particular, section 4 of the Limited Partnerships Act 1907 Act is amended such that a limited partner is entitled to withdraw the contribution it has made to the partnership. As this is of critical importance to the operation of a limited partnership as an open-ended scheme, the partnership deed must provide that the partnership is not dissolved on any person ceasing to be a limited partner, provided that there remains at least one limited partner (Regulation 3(5); FSMA section 235A(6)(e)(iii)).

Turning to arrangements in respect of the depositary, HM Treasury originally proposed that the intended depositary would be the initial limited partner. However, this suggestion has been superseded by the concept of using a "nominated partner" as the initial limited partner. The nominated partner will be party to the contractual scheme deed with the operator (most likely, the general partner) but will not be conducting a regulated activity and will not require authorisation in accordance with FSMA.

It should be noted that HM Treasury has proposed that the FCA will not be able to authorise limited partnership schemes using an "umbrella" structure. This is because HM Treasury believes there is unlikely to be a significant commercial demand for the authorisation of limited partnership schemes with sub-funds. As we understand it, HM Treasury is referring to umbrella structures under which there is pooling of the contributions of the participants and the profits or income out of which payments are to be made in relation to separate parts of the scheme property. For example, an umbrella structure would appear to include a structure where investors receive different classes of unit in respect of sub-funds for different investment areas (geographical or otherwise) and their subscriptions are pooled at the sub-fund level to be invested in that particular area.

On this basis, COLL 1.2.1A G will state that only a co-ownership scheme may be structured as an umbrella with separate sub-funds, as HM Treasury is planning to allow co-ownership schemes to be authorised as either stand-alone schemes or umbrella schemes (which will have segregated liability for the sub-funds). For example, an umbrella scheme would include schemes structured in the same way as a European SICAV or certain types of mutual fund. In addition, this may impact upon structures including certain coinvest/joint venture arrangements, which might be seen as pooling at a sub-fund level and therefore may require that the authorised top fund is set up as a co-ownership scheme.

FCA AUTHORISATION

The Regulations insert a new Chapter 3A in Part 17 of FSMA to govern the authorisation and supervision of ACS by the FCA. In accordance with such amendments to FSMA, there are certain conditions which must be satisfied in order for the FCA to authorise an ACS (which are set out in section 261D and 261E of FSMA). In summary, section 261D of FSMA requires that the following conditions be satisfied:

- **Independence:** The operator (i.e. the general partner for limited partnership schemes, unless delegated) and the depositary must be independent[4] of each other;
- **Bodies Corporate:** The operator and the depositary must each be a body corporate incorporated in the UK or an EEA State (and the affairs of each must be administered in the country of incorporation);
- **Place of Business:** The depositary must have a place of business in the UK or an EEA State and the operator must have a place of business in the UK or an EEA State (and the affairs of each must be administered in the country of incorporation) (if the operator is incorporated in another EEA State, the scheme must not be a Recognised Overseas Scheme);
- **Authorisation:** The operator and the depositary must each be an authorised person and the operator must have permission to act as operator (and be a fit and proper person to manage the ACS) and the depositary must have permission to act as depositary;
- **Name of the Scheme:** The name of the ACS must not be undesirable or misleading; and
- **Aims:** The purposes of the ACS must be reasonably capable of being successfully carried into effect.

Amended section 261E of FSMA states that the participants in an ACS must be entitled to have their units redeemed in accordance with the scheme at a price related to the net value of the property to which the units relate and determined in accordance with the scheme. This feature underlines the fact that ACSs will operate as open-ended vehicles.

INVESTOR ELIGIBILITY

Units in an ACS may be issued only to a professional investor, a large investor or an existing ACS investor. To give effect to this provision, two new Glossary terms will be added to the FCA Handbook:

4 In the UK, this requirement is construed strictly. Guidance in COLL 6.9 identifies three types of links that can compromise independence:
- The board of the operator should not be able to exercise effective control over the board of the depositary and vice versa (i.e. common directors should be avoided);
- Shareholdings in excess of 15 percent of the voting share capital are likely to lead to a loss of independence; and
- Contractual commitments or relationships which could affect independence, whether directly or indirectly.

- A “large ACS investor” will be defined as “as person who in exchange for units in the scheme (a) makes a payment of not less than £1,000,000; or (b) contributes property with a value of not less than £1,000,000”; and
- A “professional ACS investor” will be defined as “a person who falls within one of the categories (1) to (4) of Section I of Annex II (professional clients for the purpose of that directive) to MiFID”.

Limiting the potential participants in an ACS is intended to afford protection to more vulnerable investors. Furthermore, the FCA’s proposed amendments to COLL will require that the ACS deed confirm that units in the ACS can be issued only to a professional, large or existing ACS investor.

The explanatory memorandum accompanying the final Regulations also states that contractual schemes are expected to be subject to complex reporting requirements which are likely to be unsuitable for ordinary retail investors. This is part of the reason why an initial investment requirement of not less than £1 million is included as it is intended as a deterrent to retail investors who have not sought professional advice and may not possess the experience, knowledge and expertise to appreciate the risk involved.

Originally, it was proposed that “Box Management” would be prohibited under the Regulations. “Box Management” is the term used to describe trading activities undertaken by the operator on its own account to make a profit from buying and selling units between investors. However, during the consultation process, strong objections to this blanket restriction were voiced by stakeholders and, having considered consultation responses and representations by industry, HM Treasury amended its position such that an operator of a co-ownership scheme will be able to carry out such activities but the operator of a limited partnership scheme will not be similarly entitled.

The FCA has proposed to implement this restriction by preventing the operator of a limited partnership scheme from being entitled to any rights or interests in the scheme (amendments to COLL 6.2.2G(2) and 6.4.5R(3)). No thought appears to have been given as to how this restriction might impact on the usual arrangement whereby a general partner retains an interest in a limited partnership and it is assumed that the restrictions on “Box Management” will not extend to preventing standard carry/coinvest arrangements in respect of units in the ACS. Given the changes to the position on transferability in general, it is possible that the final FCA rules on this issue may be different from those previously proposed.

TRANSFERABILITY

The original consultation paper issued by HM Treasury proposed that the Regulations prohibit the transfer of units except where permitted by the FCA rules. The Government has since concluded that a blanket restriction on transfers would be disproportionate and that any restrictions upon transferability should be decided in accordance with the deed of the scheme.

Nevertheless, units in an ACS will not be capable of being transferred to a transferee outside the investor eligibility criteria outlined above. As with the eligibility criteria, the FCA has suggested amending COLL to require detailed disclosure in the instrument and prospectus of an ACS regarding transferability. For example, it is envisaged that units will be redeemed as soon as practicable after it becomes apparent that they have been vested in anyone not meeting the eligibility criteria.

REVIEW

The explanatory memorandum accompanying the final Regulations notes that the take-up of ACSs will be subject to ongoing review and comparison with anticipated benefits over a 10-year period.

The anticipated benefits provide an insight into the benefits that HM Treasury is expecting to result from the Regulations and are as follows: £180 billion of assets in UK managed funds would not be domiciled offshore; £190 billion of additional assets for UK managed funds transferred from overseas; £190 billion in additional assets domiciled in the UK by non-UK fund managers; and a significant increase in additional fund management activity in the UK. No doubt, there will be a number of observers interested to see whether such ambitions are met.

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