The Asset Management Review

Ninth Edition

Editor
Paul Dickson

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THE ASSET MANAGEMENT REVIEW

NINTH EDITION

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PREFACE

What a difference a year makes! Last year we were reflecting on the uncertain global macroeconomic outlook brought about by geopolitical factors including political uncertainty and the rise of populist movements. In the UK and Europe, we were focusing on the uncertain future of the political and regulatory relationship with the EU. We had no idea that a more wide ranging event was soon to occur . . .

One imagines that 2020 will be primarily remembered in history as the year of the novel coronavirus pandemic, and all that the inescapable event has brought. The pandemic, far from being under control globally, is distracting from other developments and causing increased fear in the financial markets of the future strength of historically safe investments.

But what about those other events that the pandemic has masked? The UK has now left the EU and seems likely to fail to reach a 'deal' with EU on the long-term relationship at the end of the implementation period in 2021. This has had, and is likely to continue to have, a potentially destabilising effect on the UK asset management sector and its clients.

Sources of global uncertainty for financial markets are on the rise, with only increasing tensions on the global political stage. There are multiple examples of foreign investment controls being tightened, sometimes for political reasons and sometimes for understandable economic ones.

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

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

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. Operational resilience – a concept

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focused on ensuring asset managers' holistic preparedness against any risk event, particularly significant operational risks – has become a significant focus point for global regulators.

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

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

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

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

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

Paul Dickson
Slaughter and May
London
August 2020

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Chapter 22

UNITED KINGDOM

Paul Dickson[1]

I OVERVIEW OF RECENT ACTIVITY

The regulatory landscape for asset management for much of this year has primarily been focused on managing the fallout from the covid-19 pandemic. Beyond this, the focus at the EU and domestic level continues to be on the reform of existing financial regulation to protect market stability and prevent the build-up of systemic risk in the financial system. Large-scale reforms have been, to a large extent, driven by European initiatives, with many new measures originating at EU level; for instance, revisions to the Alternative Investment Fund Managers Directive (AIFMD) and the UCITS IV Directive (the UCITS Directive) as part of the EU's implementation of its capital markets union initiative, the revision of the markets in financial instruments regime (MiFID II), and the introduction of a revised EU prudential framework for investment firms.[2] However, the UK authorities have also continued their focus on building fairer and more effective financial markets. The Fair and Effective Markets Review – instigated by HM Treasury and the Bank of England to focus on fixed income, currency and commodity markets – came to a close during 2015, and the outcomes of that review seek to instigate change at both a domestic and international level. The UK Financial Conduct Authority (FCA) also continues to focus its attention on the asset management sector, with recent supervisory activity including its Dear CEO letters to asset management firms in January 2020[3] setting out its supervisory focus on liquidity management and effective governance. Meanwhile, overlaying this all, the impact of Brexit still looms large.

The view of the Investment Association (IA)[4] is that asset managers emerged from the financial crisis relatively unscathed. However, a fresh wave of significant economic uncertainty, triggered by the result of the UK's referendum on membership of the European Union and the lack of agreement to date between the UK and the EU on cross-border provision of financial services following Brexit, raises concerns about the competitiveness of the UK as a global financial centre going forward. As of September 2019, the IA notes that £9.1 trillion

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

2 See Section VII of the European Overview chapter.

3 FCA, Portfolio Letter: 'Our Asset Management Supervision Strategy' and Portfolio Letter: 'Our Alternatives Supervision Strategy', both published 20 January 2020.

4 The IA was formed by a merger between the Investment Management Association and the Investment Affairs Division of the Association of British Insurers in June 2014.

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of assets are managed by UK investment managers,[5] and the UK's asset management industry is the largest in Europe, managing funds of both UK-domiciled and overseas investors. In fact, the UK accounts for around 37 per cent of all European assets under management.[6] The IA has stated that the UK's place as a pre-eminent centre of asset management has been undisputed for a number of years, but warns that this status is by no means guaranteed in the future. Aside from Brexit raising several challenges to the asset management industry in the shorter term, the IA also points to longer term factors, particularly in relation to continued access to international talent, and maintaining access to overseas markets in a potentially more protectionist world with associated regulatory divergence.[7]

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

i The Financial Services and Markets Act 2000

The main framework for the regulation of asset management activities in the UK is contained in the Financial Services and Markets Act 2000 (FSMA) and various instruments introduced under the powers contained in the FSMA.

Regulated activities

The FSMA regulates the provision of financial services, including investment services, in the UK through the concept of regulated activities that may only be carried out by persons who hold appropriate authorisations or are otherwise able to take advantage of a specific exemption from the usual authorisation requirement.[8] Regulated activities are specified activities set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (Regulated Activities Order)[9] that are carried on by way of business in connection with certain specified investments also listed in the Regulated Activities Order.[10] Specified investments include a wide range of financial products including shares, bonds, government securities, deposits, units in collective investment schemes (CISs) and contracts of insurance. The list of specified activities includes:

a dealing in investments as principal or agent;
b arranging deals in investments;
c managing investments;
d establishing, operating or winding up a CIS;
e managing an alternative investment fund (AIF);

5 The IA, A Pocket Guide to Investment Management: Investment management in the UK, 2018–19 September 2019.
6 European Fund and Asset Management Association, Asset management in Europe, 11th Edition, September 2019.
7 The IA, Asset Management in the UK 2018-2019, The Investment Association Annual Survey, September 2019.
8 Section 19 FSMA.
9 SI 2001/544.
10 Section 22 FSMA.

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f managing an undertaking for collective investment in transferable securities (UCITS) (see Section III.i);[11] and
g advising on investments.

Many investment managers and certain investment fund vehicles in the UK will require FCA authorisation as they are likely to be carrying out regulated activities, such as advising clients on investments, managing investments or dealing in investments as an agent on their clients' behalf. It is a criminal offence, potentially punishable by up to two years in prison and a fine, for any person who is not authorised or exempt to carry out any regulated activity in the UK.[12]

Financial promotion

The FSMA contains a basic prohibition on any person who is not appropriately authorised, acting in the course of business, from communicating an invitation or inducement to engage in investment activity.[13] Investment activity for these purposes includes entering or offering to enter into an agreement, the making or performance of which by either party would be a regulated activity. However, this prohibition will not apply where an appropriately authorised person has approved the content of the proposed communication or if an exemption to the basic prohibition applies.[14]

CISs

The concept of a CIS is a central part of the system of regulation of asset management vehicles in the UK. These are widely defined in the FSMA to include:

> *any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements . . . to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.*[15]

Participants in a CIS must not have day-to-day control over the management of the property.[16] In addition, the relevant arrangements must involve the pooling of participants' contributions and the profits or income out of which payments are to be made to such participants, or the

11 Activities (e) and (f) were introduced from 22 July 2013 by the Alternative Investment Fund Managers Regulations 2013. If a person has permission to manage an AIF or a UCITS scheme, they need not obtain permission to operate a CIS in respect of that AIF or UCITS scheme; however, an investment manager that manages AIFs and UCITS schemes must hold permissions for both activities.

12 Section 23(1)(b) FSMA.

13 Section 21(1) FSMA.

14 Section 21(2) and 21(5) FSMA. The exemptions to the basic prohibition on financial promotions by unauthorised persons are set out in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (SI 2001/1335) (as amended).

15 Section 235(1) FSMA.

16 Section 235(2) FSMA. The meaning of the term day-to-day control was considered by Laddie J in *Russell Cooke Trust Co v. Elliott* [2001] All ER 197, in which he concluded that the mere fact that investors have a right to be consulted or can give directions to an investment manager of a fund did not necessarily mean that they had day-to-day control over the property of that fund.

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property must be managed as a whole by, or on behalf of, the operator of the scheme,[17] or both.[18] The potentially wide definition of a CIS included in the FSMA is narrowed by the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (Collective Investment Schemes Order),[19] which excludes, among other arrangements, all bodies corporate (other than open-ended investment companies (OEICs) and limited liability partnerships), contracts of insurance, and occupational and personal pension schemes.[20] A CIS need not have any particular legal form and, subject to the exemptions outlined above, the concept attaches to a wide range of legal vehicles and contractual arrangements.

If an arrangement is classified as a CIS, a number of important regulatory consequences follow. Units (i.e., rights or interests) in a CIS are a specified investment, and establishing, operating or winding up a CIS are specified activities under the FSMA that require FCA authorisation.[21] The restrictions on financial promotion summarised above will also become relevant. Furthermore, Section 238 FSMA prohibits authorised persons from promoting or marketing unregulated CISs, such as unauthorised unit trusts (UUTs) and hedge funds, except in certain circumstances (e.g., where the promotion is made only to investment professionals).[22] The promotion of unregulated CISs, together with certain close substitutes called non-mainstream pooled investments, is prohibited to the majority of retail investors.[23]

ii FCA

The FCA is the conduct-of-business regulator for all authorised firms. It is also responsible for the prudential regulation of all firms not authorised by the Prudential Regulation Authority (PRA). PRA-authorised firms (being, broadly speaking, banks, insurance companies and certain systemically important investment firms) are dual-regulated by the PRA for prudential matters and the FCA in respect of conduct of business. Most investment managers and investment vehicles requiring authorisation are regulated solely by the FCA; however, those deemed to be of significant importance to the UK's wider financial system fall within the ambit of the PRA's supervision.

The FSMA confers a wide range of regulatory functions and powers on the FCA. The FCA's statutory objectives include:

- *a* ensuring that relevant markets function well;
- *b* protecting and enhancing the integrity of the UK financial system;
- *c* promoting effective competition in the markets for regulated financial services in the interests of consumers; and
- *d* securing an appropriate degree of protection for consumers.

Under the FSMA, the FCA has extensive rule and code-making powers; it is permitted to issue such rules that it considers necessary or expedient for the purpose of advancing one or

17 The glossary in the FCA Handbook makes clear that the term operator means the person or entity responsible for management of the scheme or property within the scheme.

18 Section 235(3) FSMA.

19 SI 2001/1062.

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

21 Articles 81 and 51ZE Regulated Activities Order.

22 Exemptions from Section 238 FSMA are set out in the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (SI 2001/1060) and the FCA's Conduct of Business Sourcebook (COBS).

23 COBS 4.12.

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more of its statutory objectives. The rules and guidance applicable to FCA-authorised firms are consolidated in the FCA Handbook, which includes high-level standards, conduct-of-business requirements, regulatory guides and specific specialist sourcebooks applicable to a wide range of asset management vehicles and arrangements.[24] The content of the FCA Handbook is heavily influenced by EU legislation; for instance, the Markets in Financial Instruments Directive (MiFID), which sets out various organisational and conduct-of-business requirements that apply to authorised investment firms.[25] The FCA substantially updated the FCA Handbook to reflect the MiFID II regime, which came into force in January 2018.

The FCA makes use of a number of supervisory tools in its oversight of the asset management industry, including thematic reviews and market studies, which involve investigations into key current or emerging risks relating to a specific issue or product.[26] Notably, the FCA recently published the final report on its wide-ranging asset management market study in June 2017. The key findings of that study focused on price competition in a number of areas of the asset management industry, fund performance, how asset managers communicate their objectives to clients, and the role of investment consultants and other intermediaries in the asset management sector (see further details in Section V.vi).

In March 2017, the FCA published the final report on its Financial Advice Market Review (FAMR). The latter was launched jointly by HM Treasury and the FCA in August 2015 to explore the ways in which the government, industry and regulators could stimulate the development of a market that delivers affordable and accessible financial advice and guidance. The final report set out a series of recommendations intended to tackle barriers to consumers accessing advice and guidance. Those recommendations fall into three key areas: the affordability and accessibility of advice, liabilities of investment advisers and redress. As part of the implementation of those measures, the report recommended that the FCA and HM Treasury should work together to develop an appropriate baseline and indicators to monitor the development of the advisory market. The FCA published its baseline report in June 2017. It launched a call for input asking for feedback on its proposed approach to reviewing the outcomes of the FAMR in May 2019, with the publication of the review findings currently expected in autumn 2020.

One key area of interest for the FCA over the past few years has been potential conflicts of interest between asset management firms and their clients, particularly in relation to the clarity of fund charges, inducements given or received by investment firms, and the way in which commissions charged to customers were spent. Prior to the implementation of MiFID II, the FCA had reformed its rules on the use of dealing commission to make clear that commissions should only be spent on the actual costs of executing customer orders, goods and services related to the execution of trades, or goods and services related to the provision of research. Under the new MiFID II inducements regime however, many asset managers are now prevented from charging clients for research on a bundled basis, and must

24 The FCA Handbook is available at www.handbook.fca.org.uk/handbook.

25 See Section III of the European Overview chapter.

26 Recent thematic reviews relevant to the asset management sector include a 2015 thematic review about benefits provided and received by firms conducting MiFID business, and those carrying out regulated activities in relation to a retail investment product: TR 16/3 Meeting of investors' expectations, TR15/1 Asset management firms and the risk of market abuse, TR14/19 Wealth management firms and private banks – conflicts, and TR14/7 Clarity of fund charges.

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either pay for the research directly from their own balance sheets or charge the costs back to clients via a special research payment account.[27] The FCA has reviewed how asset managers are implementing these rules and how firms are pricing research and corporate access services. The review concluded that the implementation of the new rules by the majority of buy-side firms has improved accountability and scrutiny over both research and execution costs, with most firms choosing to absorb research costs themselves.

Another key area of interest for the FCA has been the balance between the sustainable long-term allocations of capital by asset management firms, against the need for managing a fund's liquidity. This issue was made far more prominent by the suspension of trading in open-ended property funds run by Standard Life, Aviva and M&G (amongst others) in 2016, and the more recent collapse of Neil Woodford's Equity Income, Income Focus and Patient Capital Funds, all resulting in part due to the funds being insufficiently liquid to cope with redemption requests. This has led to a number of prospective changes to the FCA's rules concerning non-UCITS funds (discussed in greater detail below), and the FCA's continued work with the Bank of England to review how funds that invest in less liquid assets should structure their redemption options.[28]

Further, the FCA has been expanding its interest in innovation, big data, technology and competition. The FCA has set fintech as one of its cross-sector priorities, particularly noting that it is driving change in markets and encouraging innovations. The FCA has launched programmes to enable the development of fintech, for example, by providing assistance to firms using innovation to improve consumer outcomes through its Innovate programme. Firms can test the commercial and regulatory viability of their innovative concepts before investing in them in the FCA's regulatory 'sandbox'. In the context of asset management specifically, the FCA launched its Advice Unit to provide regulatory feedback to firms developing automated models to deliver lower-cost advice and guidance to consumers, and on 21 May 2018 published guidance in relation to automated investment services,[29] and specifically its approach to the supervision of automated or 'robo' advice.[30] In a review of the impact and effectiveness of its innovation programme, published in April 2019, the FCA noted that asset management was one of the sectors from which it had received comparatively low numbers of applications for the regulatory sandbox, despite proactive attempts to engage with the sector.[31]

The FCA issued its first decision under competition law in February 2019, penalising three asset managers found to have shared strategic information in relation to initial public offerings and one placing. The FCA issued fines of £306,300 and £108,600 (one of the asset managers was given immunity under the competition leniency programme), and it was widely regarded as the start of a crackdown on information sharing in equity capital markets transactions. In March 2019, the FCA also published a package of measures to improve

27 See Section III of the European Overview chapter.

28 FCA, Open-ended funds investing in less liquid assets: Speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy, to Investment Association members, 19 March 2020.

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

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

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

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competition in the investment platforms market.[32] The measures include provisions designed to allow consumers to switch platforms and remain in the same fund without having to sell their investments, together with restrictions on exit fees.

iii Brexit

The UK's withdrawal from the European Union was given legislative effect by the European Union Withdrawal Act 2018 (the Withdrawal Act), which repealed the European Communities Act 1972 and took effect on 31 January 2020 (exit day). The Withdrawal Act is subject to a implementation period between 31 January and 31 December 2020 agreed between the UK and EU under the Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community (the Withdrawal Agreement), which was implemented in the UK by the European Union (Withdrawal Agreement) Act 2020 (the Withdrawal Agreement Act). The Withdrawal Agreement Act provides that EU law will continue to have effect in the UK as if it were still a Member State, until the end of the implementation period. New EU laws that come into force in the interim likewise apply to the UK during the implementation period in a similar way as they would have prior to exit day. The UK government has given strong indications that it will not seek to extend the end of this implementation period, and the deadline specified in the Withdrawal Agreement for formally seeking an extension has now passed.

The Withdrawal Act provides a mechanism to onshore EU law into UK domestic legislation by:

a preserving any domestic legislation, subordinate legislation or rules which have implemented EU laws without direct effect (e.g., EU directives);

b converting directly applicable legislation (e.g., EU regulations and decisions) into UK domestic legislation; and

c preserving any other EU rights that currently take effect as law (e.g., directly effective EU treaty rights) as UK domestic law.

The Withdrawal Agreement Act amended the Withdrawal Act such that EU law will be onshored into UK domestic law at the end of the implementation period, as opposed to exit day. The Withdrawal Act gives HM Treasury the power to remedy deficiencies in retained EU law arising from the onshoring process and apply any other conforming changes necessary for such law to be effective (e.g., to reflect the UK's position outside of the EU). Any 'in-flight' EU legislation (i.e., any legislation that has not yet been adopted, or has been adopted but has yet to come into effect before end of implementation period) as of the end of the implementation period will not be onshored by the Withdrawal Act. However, the UK government is currently consulting on a proposed Financial Services Bill that will give HM Treasury the powers to put in place domestic regulatory regimes that are based on key pieces of in-flight EU legislation pertaining to financial services.[33] Following the end of the implementation period, since all rules deriving from EU legislation will have effect in the UK as domestic legislation, they can be revoked or amended through the normal legislative

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

33 See HM Treasury's Policy Statement, Prudential standards in the Financial Services Bill: June Update, June 2020.

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procedure applicable to UK legislation, for example under an Act of Parliament. At the time of writing, the issue of regulatory alignment between the UK and the EU remains a hotly contested political issue.

Subordinate legislation made under the Withdrawal Act also gives the PRA, the FCA and the Bank of England (among other UK regulators) the power to make instruments (which must be approved by HM Treasury) correcting similar deficiencies in any secondary EU legislation (such as implementing technical standards and regulatory technical standards) which has been onshored. HM Treasury and the regulators have exercised these powers to pass numerous statutory instruments that will come into force at the end of the implementation period. The PRA and the FCA have also made or proposed a number of changes to their rules and guidance to reflect the UK's withdrawal from the EU and the legislative changes referred to above.

The Bank of England, the PRA and the FCA have also clarified[34] that guidance issued by the European Supervisory Authorities (which supplement EU legislation) before exit day should continue to be applied by firms insofar as relevant in light of the UK's withdrawal from the EU, despite not having binding effect under UK law. Any guidance issued by the European Supervisory Authorities following exit day pertaining to the EU-derived law will also continue to be relevant after that date. The UK regulators have not articulated an updated position following the conclusion of the Withdrawal Agreement or passing of the Withdrawal Agreement Act, and will, for their part, continue to have regard to ESA materials as appropriate.

Cross-border services

During the implementation period, since EU law continues to apply without change in the UK, asset management firms based in the UK can continue to make use of passporting rights which allow them to market their services into the EEA (and vice versa). Following the end of the implementation period, however, the default position, given the UK's status as a third country, is that firms based in the UK will not be able to market services into the EU on a cross-border basis under existing passporting rights. They will hence have to apply to the relevant regulators in each member state for permission to carry out financial services in the EEA. Currently, the only exception to this default arrangement is the 'equivalence' regime, whereby under certain EU regulatory regimes, if the UK's regulatory regime is deemed 'equivalent' to that of the EU and the UK establishes a reciprocal regime for EEA-based firms to market services into the UK, UK firms will be able to rely on their authorisation in the UK to market services into the EEA. However, this mechanism applies on a per-service or per-activity basis, and does not cover all services and activities – for example, there is no equivalence regime applicable to UCITS schemes. The greater difficulty facing UK firms attempting to rely on equivalence to market their services into the EU is that a decision of equivalence can be withdrawn unilaterally by the EU. Given that both a decision to grant or withdraw equivalence will be fraught with political considerations and strongly influenced by the nature of the bilateral relationship between the UK and the EU, any reliance on such a system will result in much uncertainty for market participants.

Conversely, EEA firms currently relying on a passport to operate in the UK will need to seek authorisation to carry out regulated activities from the FCA or PRA, or both, following

34 See, e.g., FCA, Brexit Policy Statement: Feedback on CP18/28, CP18/29, CP18/34, CP18/36 and CP19/2 Appendix 3: Our approach to EU non-legislative materials, February 2019.

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the end of the implementation period. HM Treasury has introduced a temporary permissions regime to enable certain firms authorised in an EU Member State that passport into the UK to apply for 'deemed authorisation' to continue operating in the UK after the end of the implementation period for a limited period of time. This is to ensure that firms and investment funds can continue their business with minimal disruption despite the passporting regime falling away in the UK. HM Treasury has also introduced a financial services contract regime to ensure that existing contractual obligations not covered by the temporary permissions regime can continue to be met by firms after the end of the implementation period, to allow them to run down existing business. While some EU Member States have introduced their own transitional measures, at the time of writing there was no equivalent pan-EEA provision applying a temporary regime for UK firms looking to continue operating in the EU following the end of the implementation period.

One aspect of the temporary permissions regime which is of particular significance to the asset management sector is the temporary marketing permissions regime (TMPR) for UCITS domiciled in the EU, which will enable such UCITS to continue to market in the UK in a similar way as under passporting rights deriving from the UCITS Directive. Following the expiry of the TMPR, UCITS domiciled in the EU would then have to apply to be individually recognised under Section 272 of FSMA to continue marketing into the UK. In recognition of the logistical difficulties that such a procedure would entail, in March 2020, HM Treasury began consulting on an alternative, more streamlined regime based on the principle of equivalence to allow for funds marketing into the UK under the TMPR to apply for authorisation when the TMPR ceases to apply.[35] This new regime would also prospectively apply to certain funds which invest in liquid assets such as cash, government and corporate debt, known as 'money market funds', the majority of which are currently domiciled in the EU. The consultation closed in May 2020, and the government is in the midst of assessing the relevant stakeholder feedback.

III COMMON ASSET MANAGEMENT STRUCTURES

A range of legal vehicles is commonly used for asset management activities in the UK. These include limited companies, trusts and limited partnerships, as well as certain bespoke legal forms specific to the investment funds context. The choice of legal form of an investment fund will often be influenced by the tax treatment of that fund and the regulatory implications for both the fund and the fund manager that follow from that choice.

i Open-ended investment vehicles

Open-ended funds issue and redeem securities to and from investors in a fund on an ongoing basis at a price that is based directly on the underlying net asset value of the investment portfolio held by the fund. In the UK, an open-ended investment vehicle may take the form of a UUT or one of three forms of authorised CIS: authorised unit trusts (AUTs), OEICs and authorised contractual schemes. Such authorised CISs may, in turn, be UCITS schemes, non-UCITS retail schemes or qualified investor schemes, as discussed below.

35 HM Treasury, Overseas funds regime – a consultation, March 2020.

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Unit trusts and AUTs

The original form of open-ended fund in the UK is the unit trust. This relies upon the English common law concept of trust, under which a trustee holds the legal title to the trust property on behalf of the beneficiaries (in this case, the investors) who themselves have a beneficial interest in the underlying trust assets. Typically, the trustee will be a financial institution with experience in offering trust services (in the case of AUTs, it is important that the trustee is authorised under the FSMA[36]). However, unlike other general forms of trusts, there will also be a separate fund manager to formulate and implement the unit trust's investment strategy, working alongside the trustee. Trusts themselves do not have any legal personality under English law and therefore cannot contract in their own name. Instead, they are characterised by the trust relationship between the trustee and the beneficiaries, which will be established by the relevant document constituting the trust (which, in the case of unit trusts, is typically termed the 'trust deed').

An AUT scheme is defined in the FSMA as a unit trust scheme authorised in accordance with Section 243 FSMA.[37] The FCA may authorise a unit trust scheme if it is satisfied that the requirements contained in that Section are met, the rules in the FCA's Collective Investment Schemes Sourcebook (part of the FCA Handbook, commonly referred to as COLL) have been satisfied, and it has been supplied with a copy of the trust deed constituting the AUT and a certificate signed by a solicitor that states that the requirements in Section 243 and COLL have been met.

AUTs enjoy two key advantages that flow from FCA authorisation. First, an AUT is able to make invitations or financial promotions to participate in the scheme directly to the public in the UK.[38] Secondly, AUTs are not liable to pay UK tax on the chargeable gains realised on a disposal of assets in their underlying investment portfolios.[39]

It is possible for unit trusts to be unauthorised, meaning that no FCA approval has been granted under Section 243 FSMA. This has the advantage that the UUT is not subject to the detailed requirements in COLL, but it does not benefit from the exemption on the prohibition on financial promotions to the public in the UK and, unless all of the investors in the UUT are exempt from UK tax on capital gains other than by reason of their residence or the UUT benefits from pre-6 April 2014 grandfathering, it will broadly be taxed as though it was a UK-resident company. This tends to mean that unauthorised trusts are attractive to a narrower range of professional investors and are unsuitable for use as retail investor schemes.

OEICs

OEICs were introduced in the UK partly as a response to the unfamiliarity of overseas investors with the trust structure underlying unit trusts. They represent a compromise position in English law by permitting a company to have a variable capital structure.[40] In many ways, OEICs are similar to AUTs (the statutory and regulatory provisions applying to both often

36 Acting as trustee of an AUT is a specified activity under Article 51ZB (in relation to UCITS schemes) or Article 51ZD (in relation to AIFs) of the Regulated Activities Order, as applicable.

37 Section 237(3) FSMA.

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

39 Section 100 Taxation of the Chargeable Gains Act 1992.

40 Traditionally, English company law has resisted the idea of companies having variable capital, and has imposed relatively strict maintenance of capital rules that have prevented companies from being suitable

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use similar wording and concepts), but OEICs are bodies corporate and, therefore, have separate legal personality. As a result, OEICs are not based on the English law concept of the trust, and the OEIC itself will hold the beneficial interest to the investment portfolio (while the investment assets must be entrusted to a depositary, which will hold legal title to them[41]). Therefore, investors in an OEIC are, to an extent, in a similar position to shareholders in a traditional limited company. An OEIC must also have an authorised corporate director that will assume responsibility for the OEIC's ongoing operating duties.[42] Although an OEIC may theoretically have additional directors, this is rare in practice, and it is far more common for the authorised corporate director to be the sole director of the OEIC.

The Treasury is empowered under the FSMA to make rules that regulate OEICs,[43] and the current regulatory framework operates through two distinct sets of regulations: the Open-Ended Investment Companies Regulations 2001 (OEIC Regulations),[44] and those parts of COLL relevant to OEICs. OEICs are not regulated by the general company law provisions contained in the Companies Act 2006, despite their status as bodies corporate under English law.

The formation of OEICs is governed by Part II of the OEIC Regulations, which states that an OEIC is incorporated upon the coming into effect of an authorisation order from the FCA.[45] Since the only method of incorporating an OEIC is through this FCA authorisation procedure, it is not possible to have an unauthorised OEIC in the UK (unlike a unit trust, which may be either authorised or unauthorised).

To grant authorisation, the FCA must be provided with a copy of the company's instrument of incorporation and a certificate from a solicitor that attests that the instrument of incorporation complies with FCA requirements, including the inclusion of certain key statements and matters set out in Schedule 2 to the OEIC Regulations.[46] As with AUTs, OEICs must also permit shareholders to have their shares redeemed or repurchased on request at a price related to the net value of the OEIC's investment portfolio and determined in accordance with the OEIC's instrument of incorporation and the rules in COLL.[47] Alternatively, or in addition, shareholders must be entitled to sell their shares on

open-ended investment vehicles. Prior to the development of OEICs, closed-ended investment trusts (which are actually companies under English law) were the typical form of body corporate employed as a collective investment vehicle.

41 Regulation 5 OEIC Regulations.

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

43 Section 262 FSMA.

44 SI 2001/1228.

45 Regulation 3(1) OEIC Regulations.

46 These include, for example, that the OEIC's shareholders are not liable for its debts (Paragraph 2(c)), and that the charges and expenses of the OEIC may be taken out of the scheme property (Paragraph 2(e)). In addition, the instrument of incorporation must contain provisions stating the object of the OEIC (Paragraph 3(1)(a)), the currency in which its accounts are to be prepared (Paragraph 3(1)(c)), the maximum and minimum sizes of its capital (Paragraph 4(1)(c)), and the rights attaching to each class of its shares (Paragraph 4(1)(f)).

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

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an investment exchange at a price that is not significantly different from the redemption or repurchase price.[48] UK OEICs are not subject to the restriction on the promotion of CISs contained in Section 238 FSMA.[49]

Authorised contractual schemes

The Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013 (the Contractual Scheme Regulations) came into force on 6 June 2013.[50] The Contractual Scheme Regulations provide for a new form of authorised CIS: an authorised contractual scheme (ACS). Previously, collective investment activity authorised by the FCA could only be carried out through AUTs or OEICs, neither of which are tax-transparent (although neither AUTs or OEICs are generally liable to pay UK tax on the chargeable gains realised on the disposal of investment assets, nor are they generally liable to pay UK tax on their dividend income). ACSs, on the other hand, are not within the charge to direct taxes, and any tax liability is at the investor level. The introduction of ACSs is intended to increase the competitiveness of the UK's asset management industry.

The ACS may take the form of a co-ownership scheme or a limited partnership scheme.[51] An ACS is defined in the FSMA as a contractual scheme that is authorised in accordance with Section 261D(1) FSMA.[52] The FCA may authorise a contractual scheme if it is satisfied that the scheme complies with the requirements of Sections 261D and 261E FSMA; the scheme meets the requirements of the contractual scheme rules (set out in COLL); and it has been provided with a copy of the contractual scheme deed and a certificate signed by a solicitor stating that the deed complies with the necessary requirements.[53]

The general restriction on the promotion of CISs does not apply to ACSs.[54] However, to protect retail investors, an ACS must not allow retail investors to be participants in a scheme unless they invest £1 million or more.[55]

UCITS schemes

UCITS schemes are not a separate type of open-ended investment vehicle, but rather they are AUTs, OEICs or ACSs that meet the criteria laid down in the UCITS Directive. The UK has implemented the requirements of the UCITS Directive primarily through the FCA's COLL Sourcebook, and the insertion and amendment of certain provisions in the FSMA by the UCITS Regulations 2011.[56]

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

48 Regulation 15(11)(b) OEIC Regulations.
49 Section 238(4)(b) FSMA disapplies the general restriction on the promotion of CISs in Section 238(1) FSMA.
50 SI 2013/1388.
51 Section 235A FSMA.
52 Section 237(3) FSMA.
53 Section 261D(1) FSMA.
54 Section 238(4)(aa) FSMA disapplies the general restriction on the promotion of CISs in Section 238(1).
55 Section 261E FSMA.
56 SI 2011/1613.

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transferable securities[57] or in other permitted financial instruments[58] operating on the principle of risk-spreading; and the units in the fund must, at the request of the unitholders, be repurchased or redeemed, directly or indirectly, out of the scheme's assets (which includes action taken by or on behalf of the scheme on a stock exchange to ensure that the value of its units does not vary significantly from their net asset value).

Alternatively, a UCITS scheme may be an umbrella scheme, having sub-funds that each would be a UCITS scheme if they had separate FCA authorisation.

A scheme will not constitute a UCITS scheme for the purposes of the rules in the FCA Handbook if its instrument of incorporation (for an OEIC), trust deed (for an AUT) or contractual scheme deed (for an ACS) contain a provision that means that its units may only be sold to the public in non-European Economic Area (EEA) states.

UCITS schemes must comply with the general obligations applicable to UCITS funds under the UCITS Directive,[59] as well as specific investment and borrowing power rules.[60] The general UCITS investment limits have been incorporated into the UK regulatory regime through COLL, and include spread limits and specific rules for government securities and for derivatives.[61] The investment powers and borrowing limits for UCITS feeder funds are also included in COLL; these include a general obligation that a feeder UCITS must invest at least 85 per cent in value of its property in units of a single master UCITS.[62]

UCITS schemes must comply with a more stringent regulatory regime; however, until the end of the implementation period, they may continue to benefit from cross-border passporting, which allows a UCITS authorised in one EEA State to market its units into any other EEA State. Provisions allowing for the cross-border marketing of UCITS schemes of other EEA States are included in the rules for recognised overseas schemes in COLL 9 and in Section 264 FSMA. The competent authorities of the home Member State of the relevant UCITS fund are required to notify the FCA that the fund has been authorised under the UCITS Directive in that Member State, following which the fund will have the right to begin marketing units in the UK immediately.

COLL also contains the UK rules on UCITS management company passports, both in respect of UK UCITS management companies operating other EEA UCITS schemes and EEA UCITS management companies acting as authorised fund managers (AFMs) of UK UCITS schemes.[63] The rules applicable to UK management companies make clear that

57 Transferable securities are defined in COLL 5.2.7 as shares, debentures, alternative finance investment bonds, government and public securities, warrants or certain certificates conferring contractual or property rights in connection with such securities. However, under COLL 5.2.7(2), investments will not constitute transferable securities if the title to them cannot be transferred, or cannot be transferred without third-party consent (except, in the case of a body corporate, any consent required by the body corporate itself, its members or its debenture holders, which may be excluded under COLL 5.2.7(3)).

58 COLL 5.2.6A sets out the permitted types of property that may be included in the portfolio of a UCITS scheme. This includes transferable securities, approved money-market instruments (broadly speaking, liquid instruments normally traded on money markets), units in CISs, derivatives and forward transactions, and deposits. In the case of OEICs, this also includes any movable or immovable property that is essential for the direct pursuit of the OEIC's business.

59 COLL 1.2.2 and COLL 3.2.8.

60 COLL 5.2 to COLL 5.5.

61 COLL 5.2.

62 COLL 5.8.2.

63 COLL 12.

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they are subject to a range of general compliance and conduct requirements contained in COLL and in the FCA's conduct of business rules, but they also make clear that where a UK management company operates a UCITS scheme through a branch in another EEA state, it will be subject to the relevant requirements of that state's regulatory authorities so that in certain situations, regulatory responsibility may be shared between the FCA and that state's competent authorities.[64] The rules relating to EEA management companies that operate a UK UCITS (either through a branch or under a general cross-border passport) set out the requirements for certain information to be provided to the FCA in relation to depositary and delegation arrangements,[65] and the rules in COLL and the conduct of business rules to which the EEA management company is subject.[66] These include detailed rules on:

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

Non-UCITS retail schemes

Like UCITS schemes, non-UCITS retail schemes (NURSs) are not a separate type of investment vehicle, but rather are AUTs, OEICs or ACSs that do not comply with the requirements to be a UCITS. The regulatory regime applying to NURSs in the UK is less stringent than that which applies to UCITS schemes, and the applicable investment restrictions are therefore more relaxed. However, as a consequence, NURSs do not qualify for EU cross-border passporting under the UCITS regime.[67] For example, NURSs are permitted to invest up to 20 per cent of the value of the scheme property in unlisted securities or unregulated investment schemes, and may also invest in gold and real estate assets.[68] In addition, the limit for investment in the units of another authorised scheme is 35 per cent of the NURS's assets[69] (which permits a higher level of investment concentration than the 20 per cent limit applicable to UCITS schemes[70]), while the limit for a NURS's exposure to a single counterparty in an over-the-counter derivative transfer is limited to 10 per cent of the scheme value,[71] rather than the usual 5 per cent limit for UCITS schemes.[72]

Nonetheless, there are still important limitations on the investment powers of NURSs that are intended to retain a degree of investor protection in the absence of the demanding UCITS requirements. A NURS (except for a feeder NURS[73]) cannot invest in the units of a CIS unless that CIS meets certain minimum requirements, including that the CIS is effectively

64 COLL 12.2.
65 COLL 12.3.4.
66 COLL 12.3.5.
67 See the guidance in COLL 5.6.2.
68 COLL 5.6.4 and COLL 5.6.5.
69 COLL 5.6.7(6).
70 See COLL 5.2.11(9).
71 COLL 5.6.7(5).
72 COLL 5.2.11(7) (although the limit for UCITS schemes is raised to 10 per cent if the derivative counterparty is a financial institution recognised by the FCA rules as an approved bank).
73 A feeder NURS is a NURS that invests in units only in a single CIS that is itself a NURS, a UCITS scheme or a recognised overseas scheme.

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subject to an equivalent level of regulation as a NURS or UCITS fund (or otherwise that no more than 20 per cent by value of the NURS's assets are invested in that CIS); the CIS operates on the principle of the prudent spread of investment risk; and the CIS is prohibited from having more than 15 per cent in value of its property in units in other CISs.[74]

NURSs are also subject to certain of the same provisions in COLL[75] regarding:

a limiting the amount of cash that can be retained in the scheme property;[76]

b general borrowing powers;[77]

c the ability to lend money and other property;[78] and

d the power to provide guarantees or indemnities.[79]

In October 2018, the FCA began consulting on proposals to reduce the potential for harm to retail investors in funds that hold illiquid assets.[80] Consequently, the FCA announced a number of changes to its rulebook in September 2019, including the introduction of a new category of 'funds investing in inherently illiquid assets', a requirement for funds to be enhanced to increased depositary oversight, suspend trading in certain circumstances, produce risk contingency plans, and disclose more information about liquidity management tools.[81] These amended rules are targeted at NURSs in particular that invest in illiquid assets, such as property, and come into force in September 2020.

Funds of alternative investment funds

COLL includes provisions governing the operation of funds of alternative investment funds (FAIFs) that are NURSs (or sub-funds of umbrella NURSs) operated in accordance with specific rules set out in COLL 5.7 (some of which incorporate general rules that are applicable to all NURSs from COLL 5.6). The regulatory regime for FAIFs is therefore essentially a relaxed version of the rules that apply to NURSs, providing increased flexibility in respect of investment powers.

The key attribute of FAIFs is that they are permitted to invest all of their assets in CISs, provided that those CISs prudently spread risk and do not themselves invest more than 15 per cent in value of their assets in units in CISs (or, in the absence of any such restriction, provided that the fund manager of the FAIF is satisfied on reasonable grounds that no such investment will in fact be made).[82] There is no requirement that the CIS in which a FAIF invests must itself be subject to the rules governing NURSs or the UCITS requirements. However, the fund manager of a FAIF must carry out appropriate due diligence on any CIS in which the FAIF intends to invest.[83] The guidance in COLL 5.7 makes clear that

74 COLL 5.6.10.

75 COLL 5.6.22.

76 COLL 5.5.3.

77 COLL 5.5.4(1)–(3) and (8), although significantly a NURS's borrowing powers are not limited only to borrowings on a temporary basis, as COLL 5.5.4(4) and (5) do not apply to a NURS.

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

79 COLL 5.5.9.

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

81 FCA, Policy Statement, PS 19/24, Illiquid assets and open-ended funds and feedback on Consultation Paper CP 18/27.

82 COLL 5.7.2 and COLL 5.7.7.

83 COLL 5.7.9.

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this due diligence should include an assessment of, among other factors, the experience and qualifications of the CIS's investment manager, the adequacy of the CIS's governance arrangements and risk management processes, the level of liquidity and the redemption policy offered by the CIS, and any relevant conflicts of interest between the CIS's investment manager and any other parties.[84]

Qualified investor schemes

As with UCITS schemes and NURSs, qualified investor schemes (QISs) are not a specific legal form of investment vehicle. Rather, QISs are authorised CISs that are designed to be marketed only to certain types of sophisticated investors,[85] rather than to general retail customers, and the fund manager of a QIS is required to take reasonable care to ensure that the units in the QIS are sold only to such persons.[86]

The regulation of QISs is more relaxed than that of UCITS schemes and NURSs, and QISs have greater flexibility in respect of their investment and borrowing powers. The assets in which a QIS invests must be permitted investments under the QIS's constitution and its marketing prospectus,[87] but otherwise they can consist of a wide range of assets including shares, debentures, alternative finance bonds, real estate, precious metals, exchange-traded commodity contracts, options, contracts for difference and units in CISs.[88] Unlike UCITS schemes and NURSs, there are no specific rules that would limit concentration of a QIS's assets in certain investments (except for units in certain CISs), although there is a general requirement that the fund manager of a QIS must take reasonable steps to ensure that the investments provide a suitable spread of risk in light of the investment objectives of the scheme.[89] In relation to investments in CISs, a QIS may only invest in regulated CISs or schemes that otherwise meet certain minimum requirements (and if the scheme is of the latter type, the QIS must not invest more than 20 per cent in value of its assets in unregulated schemes or other QISs unless the fund manager has taken reasonable care to ensure that the target scheme complies with all relevant legal and regulatory requirements).[90]

The limitations on the borrowing powers of QISs are similarly relaxed. There is a general rule that the borrowing of a QIS must not exceed 100 per cent of the value of its assets, and the fund manager must take reasonable care to ensure that arrangements are in place that will enable borrowings to be closed out to ensure compliance with that rule.[91] However, there is no requirement that borrowings can only be of a temporary nature.

ii Closed-ended investment vehicles

Closed-ended funds differ from open-ended funds by issuing a fixed number of securities, usually determined by the fund's constitutional documents or by the general requirements of the law regulating the type of fund entity, or both, with investors realising their investment

84 COLL 5.7.11.

85 QISs fall within the definition of non-mainstream pooled investment and therefore are subject to the marketing restrictions in COBS 4.12 (see Section II.i).

86 COLL 8.1.3.

87 COLL 8.4.3.

88 COLL 8.4.4.

89 COLL 8.4.2.

90 COLL 8.4.5.

91 COLL 8.4.10.

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either by selling the securities in the secondary market or upon the winding-up of the fund at the end of its life. Therefore, unlike open-ended funds, closed-ended funds do not undergo the constant expansion and contraction of the number of securities in issue throughout their life in response to ongoing investment and redemption. In the UK, the most common closed-ended structures are investment trusts (which are actually companies) and partnerships.

Investment trusts

Investment trusts, despite their misleading name, are not trusts, but rather are public limited companies that are listed on a recognised stock exchange. As such, the usual company law provisions contained in the Companies Act 2006 apply to investment trusts, and there is no separate legal regime governing their form and structure (e.g., as there is for OEICs). However, to constitute a valid investment trust for tax purposes, a company must meet the criteria set out in Section 1158 of the Corporation Tax Act 2010 and be approved as such by HM Revenue & Customs (HMRC).

Unlike open-ended funds, the shares in an investment trust may trade at a discount or a premium to the net asset value of the company's underlying assets, depending on levels of supply and demand on the stock exchange. It is usual for the shares of investment trusts to trade at a discount, which can lead to considerable time being spent on attempting to manage the level of this discount. In particular, investment trusts commonly seek general shareholder authority (usually on an annual basis) to make purchases of their own shares in the market from time to time in order to support the price at which their shares trade.

As listed entities, investment trusts are subject to the Listing Rules (LRs) that form part of the FCA Handbook and are published by the FCA acting in its capacity as the UK Listing Authority. In particular, Chapter 15 of the LRs contains specific rules with which listed closed-ended investment funds (which includes investment trusts) must comply.[92] In addition to meeting the minimum requirements for listing that apply to all listed securities, the LRs stipulate that investment trusts must invest and manage their assets in such a way as to spread investment risk,[93] and that the board of directors of the investment trust must be able to act independently from its investment manager.[94] In addition, an investment trust must make investments in accordance with a published investment policy, and any material changes to that policy must be approved by shareholders and, if the change is not proposed to enable the winding-up of the investment trust, by the FCA.[95]

Investment trusts themselves do not require authorisation under the FSMA. However, following the implementation of the AIFMD, managers of investment trusts either require FCA authorisation or, in certain limited instances, to be registered with the FCA to carry out the activity of managing the investment trust. Investment trusts have a board of directors, but management is usually delegated to an investment management company; this external manager must therefore be authorised and comply with the requirements of the AIFMD. If the investment trust is internally managed, the investment trust itself must be authorised or registered.

92 Although LR 15 is stated to apply only to closed-ended investment funds with a premium listing, LR 1.5.1 makes clear that investment trusts will require a premium listing for their equity shares.

93 LR 15.2.2.

94 LR 15.2.11.

95 LR 15.4.2 and LR 15.4.8.

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Under the Collective Investment Schemes Order,[96] investment trusts do not qualify as CISs, and therefore the restrictions on the promotion of CISs in Section 238 FSMA do not apply.[97] However, shares in an investment trust will constitute specified investments under Article 76 of the Regulated Activities Order, and therefore they fall within the general restrictions on financial promotions.

Limited partnerships

Limited partnerships are formed under the Partnership Act 1890 and registered under the Limited Partnerships Act 1907 (LPA 1907). A limited partnership is defined as consisting of one or more general partners who are liable for all the debts and obligations of the partnership, and one or more limited partners whose liability is limited to the amount of capital that they contribute.[98] It is a key requirement of limited partnerships that the general partner alone is responsible for the day-to-day operation and management of the partnership's affairs: if a limited partner becomes involved in the management of the partnership's business, that limited partner will lose the benefit of limited liability and will be treated as a general partner.[99] For this reason, in the asset management context it is usual that an entity connected with the investment manager of a fund that is established as a limited partnership acts as general partner or that management responsibility is delegated to a third party, while investors act as limited partners.

Limited partnerships must be registered with the Registrar of Companies (which acts, for these purposes, as the Registrar of Limited Partnerships) in accordance with the provisions of the LPA 1907.

English limited partnerships do not have separate legal personality, and therefore cannot hold property or contract in their own name. Scottish limited partnerships differ in this respect: Section 4(2) of the Partnership Act 1890 makes it clear that a Scottish partnership is a legal person distinct from the persons of whom it is composed. Both English and Scottish limited partnerships are treated as fiscally transparent in the UK. In July 2015, HM Treasury consulted on proposed changes to the LPA 1907 as it applies to funds by a legislative reform order. It stated that it remains committed to exploring the possibility of allowing English limited partnerships to elect for legal personality, but that such a change would be fundamental and hence would not be possible using the proposed legislative reform order. Further work will be needed to explore the implications and legislative changes required.[100]

Limited partnerships benefit from flexible governance arrangements, as the LPA 1907 contains few rules on the division of responsibilities between the general and limited partners (other than the overriding requirement that the limited partners must not become involved in the day-to-day management of the partnership business). The general law relating to partnerships is flexible, and it is entirely possible to establish a partnership (although not a limited partnership, owing to the need for registration) without a written partnership agreement. In reality, investment funds will be constituted through a written agreement that sets out the rules and arrangements for that particular partnership. Certain changes to the

96 SI 2001/1062.

97 See Paragraph 21 of the Schedule to the Collective Investment Schemes Order.

98 Section 4 LPA 1907.

99 Section 6(1) LPA 1907.

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

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regime for limited partnerships are proposed by HM Treasury, in particular an ability for a limited partnership to be designated as a private fund limited partnership that would carry certain regulatory benefits. The timescale within which these changes will be brought about remains unclear.[101]

Most investment funds operated as limited partnerships will be CISs within the definition under Section 235 FSMA, as they will involve the pooling of investment assets in an arrangement whereby investors do not have day-to-day control over the management of the fund's property. In addition, such limited partnerships are likely to be AIFs for the purposes of the AIFMD (see Section III.iii). As a result, the fund manager (whether this be the general partner or a third-party manager) is likely to require FCA authorisation for the regulated activities of establishing, operating or winding up a CIS or for the regulated activity of managing an AIF.

Private fund limited partnerships

The private fund limited partnerships (PFLP) regime came into force on 6 April 2017 pursuant to the Legislative Reform (Private Fund Limited Partnerships) Order 2017[102] (the PFLP Order), which amended the LPA 1907 in certain respects. The PFLP regime is the result of the government's initiative to make the UK a more competitive jurisdiction for fund formation by relaxing or removing some of the more burdensome requirements of the LPA 1907 in relation to such funds, while retaining the flexibility and fiscal advantages of limited partnership structures.

A limited partnership must apply to be designated as a PFLP before it can avail itself of the PFLP regime. To be a PFLP, a limited partnership must satisfy two conditions: it must be constituted by an agreement in writing, and it must be a CIS (as defined in Section 235 FSMA, but ignoring any order made under Section 235(5) FSMA).

The PFLP regime relaxes a number of rules relating to limited partnerships as they apply to PFLPs. In particular, the regime introduces a non-exhaustive 'white list' of permitted activities that limited partners may undertake without jeopardising their limited liability status (such as consulting or advising with a general partner or any person appointed to manage or advise the partnership about the affairs of the partnership or about its accounts).[103] The PLFP regime also removes the requirement for partners to make a capital contribution to the partnership, and it removes certain other administrative burdens, such as the need to advertise changes to the partnership in the Gazette. Given that the PFLP Order overlays existing limited partnership law, it has the advantage of maintaining most of the features of the existing limited partnership law that are familiar to investors and asset managers. Crucially, the tax status of the limited partnership is not affected by the PFLP Order.

101 ibid.

102 SI 2017/514.

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

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Limited liability partnerships

Limited liability partnerships (LLPs) are a relatively recent introduction in the UK, having been created by the Limited Liability Partnerships Act 2000. They are a form of hybrid legal entity that are bodies corporate with their own legal personality,[104] but that enjoy the organisational flexibility and tax transparency of traditional partnerships coupled with limited liability for each member. LLPs must be incorporated through the Registrar of Companies.[105]

It is possible for an investment fund incorporated as an LLP to constitute a CIS under Section 235 FSMA in circumstances where the investors do not have control over the day-to-day management of the property of the LLP.[106] In practice, this will depend upon how the LLP is established and operates. Unlike limited partnerships, every member of the LLP is capable of being involved in its day-to-day operation. Similarly, FCA guidance confirms that it is possible for LLPs to fall within the definition of an AIF under the AIFMD.[107] In such cases, the appropriate FCA authorisation will be required.

iii Alternative investment funds

The UK implementation of the AIFMD, by means of the Alternative Investment Fund Managers Regulations 2013 (AIFM Regulations),[108] has resulted in a further regulatory category for investment funds: alternative investment funds (AIFs). An AIF is a collective investment undertaking[109] that raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and that is not a UCITS scheme.[110]

Like UCITS schemes, AIFs are not a separate type of investment vehicle. Rather, the AIFMD regime constitutes a further layer of regulation applicable to managers of investment funds that meet the definition above. An AIF can be open-ended or closed-ended, and constituted in any legal form, including under a contract, by means of a trust or under statute.[111] This broad definition of AIF means that many of the categories of investment fund described above and below fall within its scope, including authorised CISs that are NURSs or QISs, investment trusts, hedge funds, real estate funds and private equity funds. The majority of pension funds (unless they are co-investing with other pension funds) and all insurance funds are excluded. Where a fund does constitute an AIF, the fund itself will remain regulated in the manner set out above, but the manager of such a fund will be regulated pursuant to the AIFMD (although some obligations may indirectly affect the way in which the manager operates AIFs).

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

105 Section 3 Limited Liability Partnerships Act 2000.

106 LLPs are specifically excluded from being able to take advantage of the general exclusion for bodies corporate in Paragraph 21 of the Schedule to the Collective Investments Schemes Order.

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

108 SI 2013/1773.

109 PERG 16.2, question 2.15 provides further guidance on the definition of a collective investment undertaking. Broadly, the following characteristics should, if all apply, show that an undertaking is a collective investment undertaking: it does not have a general commercial or industrial purpose; it pools together capital raised from its investors with a view to generating a pooled return; and the investors, as a collective group, have no day-to-day discretion or control.

110 Regulation 3(1) AIFM Regulations.

111 Regulation 3(2) AIFM Regulations.

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Although the implications of the AIFMD for AIFs themselves may be relatively minor, the impact on alternative investment fund managers (AIFMs) is far greater. An AIFM is defined as a legal person, the regular business of which is managing one or more AIFs.[112] Managing an AIF means performing at least risk management or portfolio management for the AIF.[113] The AIFM may be an external manager or, if the legal form of the AIF permits internal management, the AIF itself.[114]

The various requirements of the AIFMD have been incorporated into the UK regulatory regime through the AIFM Regulations and changes to FCA rules and guidance, including the introduction of the Investment Funds Sourcebook (FUND). There is a degree of overlap, in that managers of NURSs and QISs who are authorised as AIFMs must refer to the new Sourcebook as well as to COLL. Where there is a conflict between a rule implementing the AIFMD and another rule in the FCA Handbook, the AIFMD requirements will prevail.[115] The AIFMD Level 2 Regulation[116] contains further detailed requirements relating to certain matters, including the calculation of assets under management and leverage, transparency and operating conditions.

Authorisation

An AIFM must be authorised under Part 4A FSMA to carry on the regulated activity of managing an AIF. To be authorised under Part 4A, the AIFM must comply with a number of obligations, including the following:

an initial capital requirement.[117] For an internally managed AIFM, this is at least €300,000, while an external manager must have initial capital of at least €125,000, plus an additional amount of capital calculated on the basis of its assets under management.[118] Most asset management companies already hold substantial capital pursuant to the relevant EU capital requirements rules;[119] however, this was a new requirement for private equity funds;[120]

a the AIFM must be the only AIFM of each AIF it manages;

b the persons who conduct the business of the AIFM must be of sufficiently good repute and sufficiently experienced; and

c the shareholders or members of the AIFM must be suitable taking into account the need to ensure prudent management.

The AIFMD allows for managers of portfolios of AIFs the value of whose assets under management does not exceed €100 million, or €500 million where each managed AIF is unleveraged and has a lock-in period of five years (small AIFMs),[121] to be subject to a lighter regulatory regime.

Full-scope UK AIFMs authorised under Part 4A are subject to the full requirements of the AIFMD as set out in the AIFM Regulations and FUND. Small AIFMs may also be

112 Regulation 4(1) AIFM Regulations.

113 Regulation 4(2) AIFM Regulations.

114 Regulation 4(3) AIFM Regulations.

115 FUND 1.1.2.

116 Regulation (EU) No. 231/2013.

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

118 Article 9 AIFMD.

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

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

121 Regulation 9 AIFM Regulations.

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authorised to carry out the regulated activity of managing an AIF; however, certain small AIFMs that meet the conditions in Regulation 10 AIFM Regulations need not be authorised under Part 4A and need only be registered as a small registered UK AIFM.[122] Small AIFMs are not required to comply with the requirements of the AIFMD, with the exception of certain registration, reporting and notification requirements contained in Article 3 of the AIFMD.[123] As a consequence, small AIFMs do not benefit from the AIFMD's managing and marketing passports (as available until the implementation period) unless they opt in to meet the full requirements of the AIFMD. A small authorised UK AIFM will also be subject to the relevant parts of the FCA Handbook.

A UK AIFM may manage a non-EU AIF that is not marketed in the EU provided that it complies with the AIFMD (with the exception of the requirements for a depositary and annual report). There must also be appropriate cooperation arrangements in place between the FCA and the supervisor in the country in which the AIF is established. Provisions requiring non-EU AIFMs to be authorised are expected to come into force when the passport becomes available (see Section III.iii).

Prudential and conduct of business requirements

AIFMs must comply with a number of conduct, organisational and prudential requirements.

In particular, AIFMs must implement adequate risk management systems, including by monitoring liquidity risks for each AIF under management and setting a maximum level of leverage.[124] AIFMs must also have adequate procedures and policies in relation to conflicts of interest.[125]

The most significant and controversial additions to the FCA's prudential and conduct of business rules are the AIFMD requirements relating to remuneration, delegation and depositaries. These are more restrictive than previous requirements.

AIFMs must establish, implement and maintain remuneration policies that promote effective risk management and apply to, inter alia, any senior managers and other staff whose professional activities have a material impact on the risk profiles of the AIFM or AIFs under management.[126] There are also restrictions on the levels of remuneration paid to such staff: at least 40 per cent of variable remuneration (i.e., bonuses) must be deferred for a period of at least three to five years unless the life cycle of the AIF concerned is shorter than this period. If the bonus is particularly high, at least 60 per cent must be deferred.[127]

In respect of delegation, there are a number of restrictions.[128] An AIFM must notify the FCA before any delegation arrangements become effective, and the AIFM must be able to justify the delegation objectively.[129] The AIFM must not delegate its functions to the extent

122 Broadly, Regulation 10 allows for the registration of: internally managed, closed-ended investment companies (such as investment trusts); external managers of certain property funds; and managers of European social entrepreneurship funds and European venture capital funds. Schedule 8 of the Regulated Activities Order provides for small registered UK AIFMs to be excluded from the regulated activity of managing an AIF.

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

124 FUND 3.6.3 and 3.7.

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

126 SYSC 19B.1.2 and 19B.1.3.

127 SYSC 19B.1.18.

128 FUND 3.10.

129 FUND 3.10.2.

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that it becomes a letterbox entity, and the services provided by the delegate must be reviewed on an ongoing basis. The AIFM's liability towards the AIF and its investors is not affected by the AIFM delegating its functions to a third party or by any further sub-delegation. The meaning of letterbox entity has been the subject of considerable debate. Article 82 AIFMD Level 2 Regulation (reproduced in FUND 3.10.9) lists a number of non-exhaustive situations in which an AIFM will be deemed a letterbox entity and not the manager of the AIF.

AIFMs must appoint a single depositary for each AIF, and the assets of the AIF must be entrusted to the depositary for safekeeping.[130] Rules and guidance relating to the use of such depositaries are set out in FUND 3.11. AIFMs must also ensure the proper valuation of AIF assets, conduct at least annual valuations (either internally or through an independent valuer) of the assets of each AIF and disclose the results of the valuation to investors.[131]

The European Commission has implemented a revised legislative framework for prudential requirements for investment firms, in the form of the Investment Firms Regulation[132] (IFR) and Investment Firms Directive[133] (IFD). The new framework includes a new categorisation of firms and an increase of the base capital requirements to €75,000, €150,000 and €750,000 for Class 1, 2 and 3 firms respectively. The IFD and IFR came into force in December 2019, with the IFR becoming directly applicable in EU Member States in June 2021, and transposition of the IFD into domestic law in EU Member States required by that same date. The IFD and IFR will not automatically be onshored in the UK by the Withdrawal Act, but the expectation and current clear policy intention is that the position under the IFD/IFR package will be largely implemented as a matter of national law in the UK.[134]

Transparency and disclosure

The AIFMD requires certain information to be made available to investors and the FCA by AIFMs. A UK AIFM must disclose specified information to investors (set out in FUND 3.2) for each AIF that it manages or markets, both prior to investment and on a periodic basis thereafter. For instance, it must disclose the investment strategy of the AIFM, a description of the AIF's risks and risk management, and a description of all fees that are borne directly or indirectly by investors.

The AIFM must also make an annual report available to investors[135] and regularly report to the FCA on the matters set out in FUND 3.4 (including the main instruments in which it is trading, its risk profile and, if the AIF employs leverage on a substantial basis, details of the level of leverage employed). Managers of private equity funds and hedge funds, among others, may have to report significantly more information to their investors under this regime than they previously had to.

130 FUND 3.11.4.
131 FUND 3.9.
132 Directive (EU) 2019/2033.
133 Directive (EU) 2019/2034.
134 FCA, Discussion Paper DP20/2: Prudential requirements for MiFID investment firms, 23 June 2020.
135 FUND 3.3.

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Private equity provisions

An AIFM must notify the FCA when an AIF that it manages acquires, disposes of or holds significant holdings in a non-listed company.[136] Further, when an AIF acquires, individually or jointly, control of a non-listed company, its AIFM must notify the company, the company's shareholders and the FCA, and must make various disclosures as to the intentions of the AIF with regard to the future business of the company.

In addition, there are asset-stripping provisions whereby the AIFM must use its best efforts to prevent any distributions, capital reductions, share redemptions or the acquisition by the company of its own shares in the first two years after the AIF acquires control.[137] This restriction is subject to certain qualifications; for instance, only distributions that would cause the company's net assets to fall below the subscribed capital or that would exceed available net profits are prohibited.[138] These requirements are particularly relevant to managers of private equity funds; hence, they are known colloquially as the private equity provisions.

Marketing and passporting

While the positions set out below stand correct at the time of writing, as a result of the UK's withdrawal from the EU, the existing passporting regime is expected to end following the end of the implementation period (see Section II.iii for further details).

The AIFM Regulations implement the AIFMD passporting regime under which authorised EU AIFMs are currently able to manage and market EU AIFs to professional investors in other Member States without additional authorisation. Guidance on management and marketing passports for UK purposes is set out in the FUND, Supervision (SUP) and PERG Sourcebooks in the FCA Handbook. To exercise passport rights, a UK AIFM must meet the conditions set out in Schedule 3 FSMA, including notifying the FCA of its intention to manage or market an AIF in the EU.[139] The availability of the marketing passport was originally expected to be extended to non-EU AIFs and EU AIFs managed by non-EU AIFMs in certain jurisdictions in 2015, and possibly to non-EU AIFMs wishing to market into the EU from 2018.[140] However, this has since been delayed, and considering the demands of Brexit, it is not expected to be introduced in the near future.[141] If the regime is extended, non-EU AIFMs will have to be authorised by their Member State of reference,[142] and comply fully with the AIFMD, to take advantage of the passport. Hence, at the end of the implementation period, UK AIFMs, as non-EU AIFMs, will no longer benefit from passporting rights unless otherwise agreed as part of the withdrawal agreement.

Currently, non-EU AIFs and EU AIFs managed by non-EU AIFMs may be marketed to professional investors in the UK under the national private placement regime. To do so, an AIFM must comply with certain requirements, including notification to the FCA, and

136 Regulation 38 AIFM Regulations.

137 Regulation 43(1) AIFM Regulations.

138 Regulation 43(2) AIFM Regulations.

139 See SUP 13.4.

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

141 See Section V of the European Overview chapter.

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

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compliance with the transparency requirements and private equity provisions.[143] The national private placement regime is not available to EU AIFs managed by EU AIFMs, which can now only be marketed to professional investors in accordance with the AIFMD as described above.

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

The Cross-Border Funds Marketing Directive (CBFMD) applies to both UCITS and funds under AIFMD, and is aimed at reducing regulatory barriers to cross-border distribution funds in Europe.[144] Though the CBFMD was published in the official journal on 12 July 2019, the changes under this regime are largely scheduled to take effect from 2 August 2021, as a result of which the extent to which these provisions will be replicated under the UK regime following the UK's departure from the EU on 1 January 2021 remains to be seen.

IV MAIN SOURCES OF INVESTMENT

An estimated £9.1 trillion of funds were under management in the UK at the end of 2018,[145] although the combined effect of the uncertainty caused by Brexit and the covid-19 pandemic on this figure has yet to be quantified. The UK is the second-largest global fund management centre, after the US, and is the largest centre of asset management in Europe, where it accounted for 37 per cent of all assets under management in 2019. Assets managed on behalf of European clients made up almost 24 per cent of UK-managed assets, despite strong growth in North American client assets.[146] London is the leading centre for fund management in the UK, but other large fund management centres include Aberdeen, Liverpool, Manchester, Edinburgh, Bristol, Oxford, Cambridge, Glasgow and Birmingham.[147]

The UK fund management industry has a strong international orientation: out of the £7.7 trillion of funds under management by IA members in 2018, £3.1 trillion was managed for overseas clients, which translated to earnings representing an estimated 4.3 per cent of net services exports. In addition, £1.8 trillion of funds under management by IA members in 2018 was managed for overseas funds (up from £1.7 trillion at the end of 2017), of which 79 per cent consisted of funds domiciled in Ireland or Luxembourg.

Institutional clients provide the majority of funds under management in the UK, with £4 trillion of funds under management by IA members in 2018 managed for UK institutional clients. Within this metric, 65 per cent were managed for pension funds, and 22 per cent for insurance companies.

UK investor funds under management in UK authorised and recognised funds fell by 6.6 per cent to £1.15 trillion in 2018. Of this, £150 billion was held in funds domiciled

143 Regulations 57 and 59 AIFM Regulations.

144 Directive (EU) 2019/1160. For more details on the CBFMD, see Sections IV.xi and V.iii of the European Overview chapter.

145 IA, Asset Management in the UK 2018–2019, The Investment Association Annual Survey, September 2019.

146 All figures in this section are taken from the IA, Asset Management in the UK 2018–2019, The Investment Association Annual Survey, September 2019.

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

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overseas. Net retail sales were £7.2 billion, a sharp fall of 85 per cent compared with £47.1 billion in 2017, which had seen an anomalous period of growth. This fall was, in part, due to a climate of uncertainty caused by limited economic growth prospects and global trade tensions, and partly due to a tougher regulatory stance on defined benefit pensions transfer advice following a series of mis-selling scandals, which stemmed the transfer of pension assets in 2018.

V KEY TRENDS

i Asset allocation

The past 15 years have seen a gradual reduction in the allocation of funds to equity investments, an increase in investment in bonds and generally more diversification of investments. This trend continued in 2018, particularly due to a dip in global equity markets' performance in the last quarter of 2018, and allocation to equities decreased from 40 per cent in 2017 to 36 per cent in 2018. This was matched by an increase of 1.8 per cent in both fixed income and 'other' asset classes, with 33 per cent and 23 per cent shares of total assets respectively.[148]

Following the UK government's implementation of lockdown measures in response to the covid-19 pandemic, retail funds experienced record net retail outflows of £10 billion in March 2020 as investors reacted to these measures. However, while all other equity regions experienced outflows, UK equity funds returned to inflows, with net retail sales of £747 million in March 2020.[149]

ii Concentration and consolidation

The top five fund managers by UK assets under management decreased slightly to 42 per cent of total funds under management from 43 per cent in 2018, and the top 10 managers managed 57 per cent.[150] Overall, the UK fund management industry remains a highly competitive environment, with considerable change outside these top 10 firms. The proportion of assets under management by stand-alone asset management firms stood at 44 per cent as of 2018, a large increase from the 21 per cent in 2008. This reflects a trend over recent years of stand-alone asset managers having increasing significance; in 2003, they accounted for 11 per cent of assets under management in the UK.[151] There was a particularly significant increase from 2008 to 2009, reflecting a wave of divestments by banks as part of their post-2008 restructurings, such as the acquisition of Barclays Global Investors by BlackRock in June 2009.[152] Merger and acquisition activity has continued in the fund management sector, with the strength of activity in recent years continuing. Notable recent large deals

148 IA, Asset Management in the UK 2018–2019, The Investment Association Annual Survey, September 2019.

149 IA, Funds hit by £10bn outflows in March when lockdowns began, 7 May 2020.

150 IA, Asset Management in the UK 2018–2019: The Investment Association Annual Survey, September 2019.

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

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

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involving UK firms include the acquisition by Schroders of Thirdrock, the acquisition of Sanlam's Bond Fund by Man GLG,[153] and Standard Life Aberdeen's acquisition of Grant Thornton's advisory division and BDO's Northern Ireland wealth unit.

iii Corporate governance

The UK Stewardship Code (Stewardship Code) was first published by the Financial Reporting Council (FRC) in July 2010, with the aim of improving the engagement of firms who manage assets on behalf of others with the companies in which they invest. It is directed at institutional investors with equity holdings in UK listed companies, and sets out seven principles covering the monitoring of and engagement with companies on matters such as strategy, performance, risk, remuneration and corporate governance. The FRC finished consultations on the latest edition of the Stewardship Code in March 2019,[154] and published the UK Stewardship Code 2020 in October 2019, which took effect at the start of January 2020.[155] The revised Stewardship Code specifically considers the separate positions of asset owners, such as pension funds and insurance companies, and service providers as well as asset managers. It also includes new requirements for investors to report how their purpose, values and culture enable them to meet their obligations to clients and beneficiaries. Lastly, it refers to environmental, social and governance (ESG) factors, and expects investors to exercise stewardship across a wider range of assets where they have influence and rights (i.e., beyond listed equity). The IA published the executive summary of its response to the proposed revisions to the Stewardship Code in March 2019, voicing its concerns that, among other things, the revised definition of stewardship conflicts with asset managers' and owners' fiduciary duties, and the Stewardship Code is excessively prescriptive and insufficiently flexible. The FRC has largely taken these concerns on board, and has restricted the definition of stewardship to the primary creation of long-term value for clients and beneficiaries with sustainable benefits for the economy, environment and society. It has also removed separate guidance from the Stewardship Code, instead incorporating examples into the reporting expectations that accompany the Stewardship Code's Principles.[156]

The Stewardship Code is of particular significance to those pension funds that delegate investment management to others; they are expected to satisfy themselves that they have in place a process for monitoring how their asset managers apply the Stewardship Code.[157] They are also expected to ensure that managers are adhering to a fund's stewardship policy, and to seek to hold their managers to account for their stewardship activities.[158]

Since 6 December 2010, UK-authorised asset managers have been required by the FCA to disclose whether they comply with the Stewardship Code. The IA has published the results of its survey on how investment managers have complied with the Stewardship Code; as of 30 September 2016, managers and owners surveyed tended to have a public policy statement

153 IA, Asset Management in the UK 2018–2019: The Investment Association Annual Survey, September 2019.

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

155 FRC, Revised and strengthened UK Stewardship Code sets new world-leading benchmark, October 2019.

156 FRC, Feedback Statement: Consulting on a revised UK Stewardship Code, October 2019.

157 See NAPF, UK Stewardship Code: Guidance for Investors, November 2010, and Principle 8 of FRC, UK Stewardship Code 2020, October 2019.

158 See NAPF, Stewardship Policy 2012, November 2012, and Principle 8 of FRC, UK Stewardship Code 2020, October 2019.

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on how they will discharge their responsibilities under the Stewardship Code. Of the 77 asset managers surveyed, all except two were signatories to the Stewardship Code. Around half of the 51 asset owners surveyed were also signatories. In particular, asset managers noted that a large majority of their institutional clients expect them to exercise stewardship.[159] A further survey published in November 2018 found that all respondents (59 asset managers) except one were signatories to the Stewardship Code.[160] The latest edition of the UK Corporate Governance Code was published by the FRC in July 2018,[161] with revisions aligned with those in the 2019 Stewardship Code.

In June 2011, the government established the Kay Review, which was tasked with reviewing the operation of the UK equity markets and their impact on the long-term performance and governance of UK quoted companies. The final report, published in July 2012, stated that asset managers have become the dominant player in the investment chain, and the appointment and monitoring of asset managers is too often based on short-term relative performance.[162] The report recommended that asset managers should contribute more to the performance of businesses through greater involvement in the companies in which they invest, and suggested that the Stewardship Code should be developed to incorporate a more expansive form of stewardship, encompassing strategic issues as well as corporate governance.[163] In line with this recommendation, the 2012 edition of the Stewardship Code emphasised that stewardship should include matters of company strategy, and has continued in the 2020 edition of the Code. The report also recommended that all participants in the investment chain, including asset managers, should be subject to fiduciary standards in relation to their clients, which should not be overridden by contractual terms in investment management agreements. In October 2014, the Department for Business, Innovation and Skills reported on the UK's progress in implementing the Kay Review recommendations. It noted that good progress had been made, and that initiatives were in place to encourage effective shareholder engagement and stewardship investment, improve the quality of reporting and dialogue in the investment chain, and build trust-based relationships and align incentives through the investment chain.

iv The Retail Distribution Review

In June 2006, the FSA launched a review of retail distribution in the UK with the aim of helping consumers to achieve a fair deal from the financial services industry, and to have confidence in the products they buy and the advice they take.

The rules implementing the outcomes of the Retail Distribution Review came into effect on 31 December 2012, and apply to all advisers in the retail investment market, regardless of the nature of firms. The rules aim to improve clarity for investors and reduce the conflicts of interest that previously arose from the remuneration of financial advisers. They prevent commission payments, and require advisory firms to disclose explicitly and charge

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

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

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

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

163 ibid., p. 45.

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clients separately for their services. Firms are also required to describe their advisory services clearly as either independent or restricted. In addition, the rules require individual advisers to adhere to consistent professional standards.[164]

The FCA carried out a post-implementation review of the Retail Distribution Review in 2014, which found that the Retail Distribution Review had generally had a positive impact on the industry, for example through increasing levels of professionalism and decreasing product bias and product charges. As a follow-up, the FCA published a call for input in May 2019 to assess the impact of the Retail Distribution Review (alongside its review of the Financial Advice Markets Review) against a set of expected outcomes and indicators, and expects to publicise the findings from this review in autumn 2020.

v The Fair and Effective Markets Review

In June 2014, the Chancellor of the Exchequer and the Governor of the Bank of England launched a review aimed at reinforcing confidence in the wholesale fixed income, currency and commodities (FICC) markets: the Fair and Effective Markets Review.

The final report of the Fair and Effective Markets Review, published on 10 June 2015, set out 21 recommendations to promote fairer FICC market structures while also enhancing effectiveness. A further implementation report was published on 28 July 2016.

The recommendations also include extending the senior managers and certification regime (SMCR) to cover a wider range of firms that are active in FICC markets. The report notes that this would include: MiFID investment firms, including asset managers and interdealer brokers; hedge funds under the AIFMD; and fund managers under the UCITS Directive. The government has implemented this change via the Bank of England and Financial Services Act 2016, which makes provision for the extension of the senior managers and certification regime to all UK authorised firms (including the asset management firms mentioned above). The FCA published final rules in July 2019 extending the scope of the SMCR to all FCA solo-regulated firms,[165] some of which took effect in December 2019. Other requirements, such as conduct rules applicable to staff of solo-regulated firms outside of the senior managers regime and the requirement for firms to assess the fitness and propriety of their certified staff, were meant to have been complied with by December 2020, but this deadline has been extended to March 2021 in recognition of difficulties following the covid-19 pandemic.

vi The asset management market study

In November 2015, the FCA launched the asset management market study, a review of the asset management sector, with a view to understanding how the retail and institutional asset management sector works for investors. The FCA published an interim report in November 2016, followed by its final report, together with a further consultation on implementing certain conclusions of the study in June 2017.[166]

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

165 FCA PS19/20, PS19/20: Optimising the Senior Managers & Certification Regime and feedback to CP19/4.

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

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In its final report,[167] the FCA stated that it had concerns about weak price competition in the asset management sector, particularly in relation to active mandates for retail clients, in respect of which it concluded that price competition is not working as effectively as it could be. The FCA also considered whether there is a relationship between fund performance and the level of fees charged by managers, and concluded that both actively managed funds and passive funds – for retail and institutional investors – failed to outperform their own benchmarks once fees were taken into account. Additionally, the regulator noted that it had concerns about how managers communicate investment objectives with their clients, particularly in relation to retail investors. Finally, the FCA voiced concerns about the role of investment consultants and other intermediaries in the asset management sector, particularly in relation to competition among investment consultants.

The FCA proposed certain remedies to the issues it identified in its final report. One of those remedies included proposals to strengthen the duty of asset managers to act in the best interests of their clients, and a proposal for consultations on requiring managers to return certain box profits to their funds and making it easier for managers to switch investors to cheaper share classes. Other measures were aimed at increasing price competition in the asset management sector, including the FCA restating its support of the disclosure of an 'all-in' fee to investors, and the consistent and standardised disclosure of costs and charges to institutional investors. The FCA also stated that it would make a reference to the Competition and Markets Authority (CMA) to develop the FCA's investigation to date into the investment consultant and fiduciary management sector. The CMA launched a market investigation into investment consultants on 14 September 2017, which culminated in the publication of a final report in December 2018 and a package of reforms, including a recommendation to HM Treasury to broaden the FCA's regulatory scope to include the activities of investment consultants.[168]

In April 2018, the FCA finalised a number of the proposed remedies outlined in its final report, including measures to improve fund governance.[169] The proposed measures focus on the duty to act in the best interests of clients, in line with the FCA's final report, and include rules that will require AFMs to carry out an assessment of whether funds managed by them will deliver value to investors. AFMs will then have to publish an annual statement assessing this value, either in the fund's annual report or in a separate report. Additionally, the new rules will make it easier for AFMs to move investors to cheaper but otherwise identical classes of the same fund by removing the need for an AFM to seek consent from each investor before converting them to a different share class. In February 2019, the FCA also set out final rules that require AFMs to explain why they have used a benchmark in a fund's prospectus and other consumer-facing communications that include fund-specific information and that, where an AFM describes a fund's past performance, it should describe such performance against the relevant benchmark.[170] The new rules also include requirements relating to how performance fees are calculated, and disclosure of fund objectives and investment policies.

The FCA has separately carried out an additional review of governance standards for unit-linked funds (whose performance determines the benefits due to holders of unit-linked

167 FCA MS15/2.3, Asset Management Market Study Final Report.

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

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

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

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insurance contracts). The results of this review, published in September 2019, highlighted concerns around the limited consideration of unit holders' interests in decision-making around levels of fees and charges, low levels of price competition in the market, and the limited impact of independent governance bodies. The FCA is currently assessing the findings of this review and may implement remedies in the future.[171]

vii Responsible and sustainable investment

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

On climate change in particular, there has been a hive of activity in recent years. In 2017 the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) developed voluntary, climate-related financial risk disclosures, with the aim of providing decision-useful information to companies' stakeholders. In the UK, there has also been growing interest in climate-related financial risks among its regulatory bodies. In 2018, the FCA published a discussion paper on climate change and green finance, which considers, among other things, a 'comply or explain' approach to the TFCD's disclosures.[172] This was followed by a feedback statement in October 2019[173] setting out the FCA's next steps to improve climate change disclosures by issuers and the provision of information on 'green' financial products and services to consumers. The FCA is also currently consulting on extending the applicability of the 'comply or explain' approach to TFCD recommendations to UK companies with a premium listing.[174] In April 2019, the PRA and FCA hosted the first meeting of the Climate Financial Risk Forum (CFRF), bringing together representatives from across the financial sector, including asset managers, in order to share best practice and produce practical guidance to further the financial sector responses to the financial risks from climate change. In June 2020, to complement ongoing work by both the FCA and the PRA, the CFRF published a guide with practical recommendations to firms centred on four key areas – management of climate-related financial risk, modelling of future scenarios, climate-related financial disclosures, and innovating in product, service and policy development.

VI SECTORAL REGULATION

i Insurance

The UK insurance industry is the largest in Europe and the fourth-largest in the world. It contributes significantly to the UK economy, managing investments of over £1.7 trillion and paying nearly £12 billion in taxes to the government in 2018.[175] UK insurance funds represented 13.8 per cent of funds under management in the UK in 2018. Around 42 per cent of insurance companies' assets are managed by in-house asset management subsidiaries, with

171 FCA, Unit-linked funds' governance review (follow up to PS18/8): findings and next steps, 24 September 2019.

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

173 FCA. Feedback Statement FS19/6, Climate Change and Green Finance, October 2019.

174 FCA. Consultation Paper CP20/3, Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations, March 2020.

175 Association of British Insurers, UK Insurance & Long-term Savings – Key Facts, December 2019.

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the remaining funds outsourced to third-party asset management firms. There has recently been an accelerating trend towards third-party management due to increased merger and acquisition activity.[176]

In terms of asset allocation, the proportion of UK quoted shares held by insurance companies was estimated at 4 per cent at the end of 2018,[177] continuing the fall seen in recent years and the lowest percentage since 1963 (when records began).[178] This decrease reflects a move from investment in UK equities to overseas securities and mutual funds. This trend is partly attributable to shift towards passive investment strategies.[179] Insurers may also have been pushed to become more cautious by solvency requirements.[180] Asset allocation may be further affected by recent changes to the regulatory regime. In particular, the transposition of the European Solvency II Directive (Solvency II),[181] which came into effect on 1 January 2016, is likely to have an impact on the way in which asset managers invest insurance assets, as certain asset classes now attract higher capital charges than others.

Insurers in the UK are dual-regulated, in that they are subject to prudential regulation by the PRA and are regulated by the FCA in respect of conduct of business. The investment of insurers' assets is subject to restrictions arising from the prudential regulatory regime for insurers, which in the UK is set out in the PRA Rulebook. The PRA Rulebook reflects, and expands upon, the requirements of various European directives. The Solvency II Regulations[182] were made on 6 March 2015, making a number of amendments to the FSMA and other primary and secondary legislation. Alongside these changes, the PRA and the FCA have made a number of amendments to their respective rules to reflect the changes required by Solvency II. These amendments came into force on 1 January 2016. In addition, insurers are subject to directly applicable regulations adopted by the European Commission pursuant to Solvency II.

The requirements of the relevant European directives have been supplemented and elaborated on in the UK regulatory regime. Aspects of the UK regulatory regime that may affect investments made by insurers include the permitted links regime and requirements that apply to with-profits business.

The permitted links regime

Rule 21.3.1 of the FCA's COBS Sourcebook stipulates that insurers are not permitted to provide benefits under linked long-term contracts of insurance that are determined by reference to fluctuations in any index that is not an approved index,[183] or by reference to the value of, income from, or fluctuations in the value of, property, other than property that is on the list of permitted links set out in COBS 21.3.1(2). Under Solvency II, the UK has preserved the permitted links regime, but has amended it to meet the Solvency II requirements that it can only apply where the direct investment risk is borne by a policyholder who is a natural

176 IA, Asset Management in the UK 2018–2019: The Investment Association Annual Survey, September 2019.

177 Office of National Statistics, Ownership of UK Quoted Shares: 2018, 14 January 2020.

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

179 Office of National Statistics, Ownership of UK Quoted Shares: 2018, 14 January 2020.

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

181 Directive 2009/138/EC.

182 SI 2015/575.

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

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person (e.g., a defined contribution pension scheme member) and that it must not be more restrictive than the regime for CISs under the UCITS Directive. As a result of this, the list of permitted links has been extended to include approved money market instruments. Insurers offering linked policies to policyholders that are not natural persons now fall outside the rule in COBS 21.3.1 and so are able to link benefits to any type of asset as long as they continue to comply with relevant prudential requirements.[184] In March 2020, the FCA also introduced a 'conditional permitted links' regime to remove some of the restrictions on investing in illiquid assets (aside from land and property), setting an overall limit of 35 per cent on the proportion of the fund that may be invested in these assets and set of conditions aimed at protecting policyholders.[185]

Under the Solvency II regime, insurers are allowed to use derivatives to cover their technical provisions in respect of linked business without being subject to the requirement that derivatives are held only for the purpose of efficient portfolio management or reduction of investment risks, unless the assets are held in respect of any guarantee of investment performance or other guaranteed benefit provided under the linked long-term contract of insurance.[186] However, any use of derivatives will still need to satisfy the prudent person principle more generally.

With-profits business

A peculiarity of the UK regulatory regime for insurance is the additional layer of requirements for with-profits funds (long-term insurance funds in which policyholders are eligible to participate, broadly, in any excess of assets over the liabilities of the fund). Additional conduct of business rules, set out in COBS 20, apply to the management of these funds, and additional prudential requirements are set out in the With-Profits part of the PRA Rulebook for both Solvency II and non-Solvency II firms. Under Solvency II, additional conduct requirements, but not additional prudential requirements, continue to apply to in-scope firms.

ii Pensions

Occupational pension schemes do not fall within the scope of the MiFID regime and are not CISs under FSMA; however, the investment of fund assets is generally delegated to an external fund manager who is likely to be subject to those regulations. The investment of the assets of occupational pension schemes is, however, subject to restrictions in the Pensions Act 1995 (as amended by the Pensions Act 2004) and the Occupational Pension Schemes (Investment) Regulations 2005 (the Pension Schemes Regulations).

Subject to any restriction in a scheme's trust deed and rules, pension scheme trustees have the power to invest the scheme's assets as if absolutely entitled to those assets and to delegate investment management to a fund manager, provided that manager is either authorised or exempt for the purposes of the general prohibition in the FSMA.[187] Trustees will not be responsible for the acts or default of a fund manager provided they take reasonable steps to satisfy themselves that the manager has appropriate knowledge and experience for managing the investments of the scheme, and carries out his or her work competently and

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

185 FCA, Policy Statement PS20/4: Amendment of COBS 21.3 permitted link rules, March 2020.

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

187 See Section II.i.

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in compliance with provisions governing his or her investment choices.[188] The trustees must ensure that a statement of investment principles (a written statement of the principles governing decisions about investments for the purposes of the scheme) is prepared and revised on a regular basis.[189] The statement must cover various matters, including the trustees' policies in relation to:

a the kinds of investments to be held;
b the balance between different kinds of investments;
c risks, including the ways in which risks are to be measured and managed;
d the expected return on investments;
e the realisation of investments; and
f the extent (if any) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.[190]

Where trustees make investment decisions (rather than delegating to a fund manager), they are also required to obtain and consider proper advice as to whether a particular investment is satisfactory, having regard to the requirements of the Pension Schemes Regulations and the statement of investment principles. If the provision of the investment advice constitutes a regulated activity for the purposes of Section 19 of the FSMA, proper advice must be given by a person entitled to give it (i.e., by an authorised or exempt person).[191]

Regulation 4 of the Pension Schemes Regulations sets out the manner in which trustees' investment powers in relation to a scheme's assets must be exercised and the restrictions on the assets in which trustees can invest. The scheme's assets must be invested in the best interests of the members and beneficiaries.[192] Investment powers must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio, and assets must be properly diversified so as to avoid accumulations of risk in the portfolio as a whole.[193] Scheme assets must consist predominantly of investments admitted to trading on regulated markets, and investments in assets that are outside of this category must be kept to a prudent level.[194] In addition, derivative instruments may only be used to the extent that they contribute to a reduction of risks or facilitate efficient portfolio management.[195]

The requirement for scheme assets to consist predominantly of investments admitted to trading on a regulated market does not prevent a pension scheme from holding investments in investment funds as it is permissible to look through investments held in a CIS to the underlying assets.[196] In addition, pension schemes are not restricted from investing in

188 Section 34 Pensions Act 1995.
189 Section 35 Pensions Act 1995 (as amended by the Pensions Act 2004). Regulation 2(1) of the Occupational Pension Schemes (Investment) Regulations 2005 specifies that the statement of investment principles should be reviewed at least once every three years, and in any event following any significant change in investment policy.
190 Regulation 2(3) Occupational Pension Schemes (Investment) Regulations 2005.
191 Section 36 Pensions Act 1995.
192 Regulation 4(2) Occupational Pension Schemes (Investment) Regulations 2005.
193 Regulation 4(3) and (7) Occupational Pension Schemes (Investment) Regulations 2005.
194 Regulation 4(5) and (6) Occupational Pension Schemes (Investment) Regulations 2005.
195 Regulation 4(8) Occupational Pension Schemes (Investment) Regulations 2005.
196 Regulation 4(9)(a) Occupational Pension Schemes (Investment) Regulations 2005.

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qualifying insurance policies,[197] such as annuities, which are treated as investments on a regulated market and, to the extent that the assets of a scheme consist of such policies, they are deemed to satisfy the requirement for proper diversification.[198]

There is a *further require*ment for defined benefit pension schemes in Regulation 4(4), which prescribes that the assets held to cover a scheme's technical provisions (i.e., the value of the scheme's defined benefit liabilities) must be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme.

The major trend in pension fund investment over the past two decades has been a fall in the proportion invested in equities. A number of factors are likely to have contributed to this trend. In addition to the stock market downturn of 2000 to 2003, and the Myners Report of 2001 (which recommended an increased focus on strategic asset allocation), investment strategies have been influenced by the closure of defined benefit schemes to new members and their consequent maturation, and by the introduction of new accounting standards. Many defined benefit schemes, established in the 1950s and 1960s, are now in maturity, and their fund managers have sought to de-risk and pursue more liability-driven investment strategies, where the assets invested in are matched to the fund's liabilities to its members. The FRS17 accounting standard, introduced in 2001 and mandatory from January 2005, states that pension schemes' funding positions must be recognised on company balance sheets, meaning that a company's pension scheme deficit would affect its financial results.[199] FRS102, which is mandatory for accounting periods beginning on or after 1 January 2015, also contains this requirement.[200]

As the number of active members in defined benefit schemes has fallen, contributions to defined contribution (or money purchase) schemes have risen, and their importance will continue to increase as they replace the closing defined benefit schemes. During 2012, the government introduced reforms to enrol employees into employee pension schemes automatically, with the ability to opt out, in contrast to the previous system, which enabled employees to opt in to their employer's pension arrangements if any such arrangements were available. This has, according to the Pensions Policy Institute, made a 'phenomenal change to pensions landscape' in the United Kingdom, and could lead to the number of people saving in private sector pension schemes increasing to up to 14.5 million by 2030, with up to £495 billion in defined contribution assets (as against a forecast of six million savers and £350 billion in defined contribution assets without automatic enrolment).[201]

Further significant reforms came into force in April 2015, which included removing the requirement for savers with 'money purchase' schemes to purchase an annuity, thereby increasing the flexibility for individuals when they draw their benefits on retirement. New governance requirements for trustees of defined contribution schemes and restrictions on charges in those schemes were also introduced in April 2015. In its 2014 budget, the government announced plans to introduce legislation to allow new pension scheme products

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

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

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

200 Section 28: Employee Benefits.

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

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in the UK based on the 'collective defined contribution' scheme model, in which investment of savers' individual funds is pooled to facilitate the sharing of risk and generate economies of scale. However, the legislation providing for this has not yet come into force.

On 18 June 2018, the Department for Work and Pensions published a response to the Law Commission's report on social impact investing. The response also announced the launch of its consultation to clarify and strengthen trustees' investment duties, aimed in part at giving effect to the requirements of the revised Shareholder Rights Directive[202] (SRD II).[203] This led to a set of amendments to the Pension Schemes Regulation that took effect on 1 October 2019.[204] These included new requirements for trustees to, among other things, update their statement of investment principles to clarify how they take account of financially material considerations, including: ESG issues such as climate change; their policies on the stewardship of investments; and a statement on how they will take account of members views of, for example, ESGs.

The Department for Work and Pensions published a further set of amendments to the Pension Schemes Regulations in June 2019 with particular relevance to asset managers, requiring trustees of both defined benefit and defined contribution pension schemes to ensure that the statement of investment principles sets out their policies in relation to their arrangements with asset managers. In particular, the statement should detail the duration of the arrangement, how the scheme incentivises the asset manager to align its investment strategies and decisions with that of the trustees, and how they monitor portfolio turnover costs incurred by the asset manager.[205] These amendments also took effect in October 2019.

iii Real property

Background

Traditionally, UK commercial property has often been held through various offshore vehicles, including Jersey property unit trusts, to take advantage of favourable offshore tax treatment. It is also common for investors to hold property through UK listed property companies (in addition to unit trusts) that allow pooling of assets to overcome cost-related barriers to entry into the property market, and to take advantage of a lower rate of stamp duty levied on transactions involving shares than is payable in respect of direct transactions involving real property. However, investing in this manner puts shareholders at a disadvantage when compared with investing directly in property because of the possibility of double taxation.

Real estate investment trusts

Since 2007, it has been possible in the UK to establish real estate investment trusts (REITs), which, like other investment trusts, are actually companies that invest specifically in real estate and receive an advantageous tax treatment in that profits and gains arising from the company's property rental business are exempt from corporation tax. In order to obtain this tax treatment, a number of detailed conditions have to be fulfilled and notice must

202 Directive (EU) 2017/828.

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

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

205 Department for Work and Pensions, The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019/982, June 2019.

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be given to HMRC.[206] These conditions include requirements that the REIT distributes at least 90 per cent of the profits from its real estate investment business and that the REIT's ordinary share capital is listed or admitted to trading (and is actually trading) on a recognised stock exchange. The latter requirement is satisfied if the shares are traded on the Alternative Investment Market (AIM) of the London Stock Exchange or a similar recognised stock exchange overseas. REITs must also be widely held, unless they are owned by certain 'institutional investors' such as pension funds.

The British Property Federation website listed 48 UK REITS as of July 2019.[207] Data published by the Investment Property Forum indicates that in 2018, UK REITs and listed property companies together held commercial property valued at £71 billion,[208] down from 74 billion in 2016.[209]

UK REITs are not CISs for the purposes of the definition in Section 235 FSMA; however, they may be AIFs.[210] The FCA has indicated that a REIT is a concept used for tax purposes, and so there is no presumption as to whether a REIT is an AIF: this will be considered on a case-by-case basis.[211]

Property authorised investment funds

Since 6 April 2008, it has also been possible to establish a property authorised investment fund (PAIF) in the UK to act as a tax-efficient vehicle for a property investment business. In contrast to REITs, PAIFs do not need to be listed or traded on a recognised stock exchange, but they must be structured as OEICs, meaning that they do not benefit from the exemption from the definition of CISs available to other bodies corporate, and must therefore be authorised by the FCA.

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

iv Hedge funds

As hedge funds are typically located in offshore jurisdictions (largely owing to the favourable tax treatment that can be obtained in those territories), there are relatively few UK-based hedge funds. However, London remains one of the largest global centres for hedge fund managers. In practice, the regulation of hedge funds under English law has therefore tended to focus on the managers themselves, rather than the fund entities, which tend to be beyond the UK's jurisdictional reach. All hedge fund managers, like other investment managers, are

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

207 www.bpf.org.uk/reits-and-property-companies.

208 Investment Property Forum, The Size and Structure of the UK Property Market: End-2018 Update, December 2019.

209 Property Industry Alliance, Property Data Report 2017, September 2017.

210 See the discussion of CISs in Section II.

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

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likely to be undertaking activities that constitute a regulated activity for the purposes of the FSMA and the Regulated Activities Order.[212] As a result, they must have the necessary FCA authorisations to carry out such activities.

Certain funds that invest in underlying hedge funds (funds of funds) may be based in the UK and may be listed on the London Stock Exchange as investment trusts. As discussed earlier, investment trusts are not CISs for the purposes of the FSMA and do not require FCA authorisation themselves. Nonetheless, the investment manager of an investment trust will still need to be authorised. The advantage of a UK-listed fund of funds is that it can provide an indirect route to investment in multiple underlying hedge funds while still requiring adherence to the continuing obligations and reporting requirements contained in the UK Listing Authority's Listing Rules.

In the past, the FSA (predecessor to the FCA) took the view that hedge fund managers, by virtue of managing offshore funds, have a low impact on the UK financial markets and represent little risk to UK retail investors.[213] The FSA, therefore, made a conscious decision not to allocate a large amount of its supervisory resources to hedge fund managers. However, in recent years the regulator has become increasingly interested in the activities of hedge funds, and the potential systemic risks posed by the disorderly failure of such funds, particularly as counterparties to trades with financial institutions and others within the financial markets.[214] The risks associated with hedge funds are reviewed on an ongoing basis, and the FCA has significantly increased its scrutiny of the hedge fund industry, including through enforcement action taken against hedge fund managers and their staff. In January 2020, the FCA published a 'Dear CEO' letter to firms managing 'alternative' investment vehicles (such as hedge funds and private equity firms) highlighting a number of risks that AIFMs posed to customers, such as low standards of governance, insufficient consideration of the appropriateness of investment products offered, and insufficient controls around client assets. The letter suggests that the FCA intends to take future action in this sector to address these issues.

UK regulation of hedge funds is also led by the overarching provisions introduced by EU legislation such as the AIFMD. There has been recent growth in the number of UCITS-compliant hedge funds,[215] the managers of which will not be required to comply with the AIFMD but will nevertheless likely require FCA authorisation for carrying out regulated activities as described above.[216] Non-UCITS hedge funds are likely to fall within the definition of AIFs; the managers of such funds, as AIFMs, are subject to the requirements of that regime.

In 2008 the Standards Board for Alternative Investments (SBAI) (the Hedge Fund Standards Board, as it then was) was established to act as an industry body to represent hedge funds and to improve standards across the hedge fund industry. The SBAI publishes the Hedge Fund Standards, which are designed to encourage greater transparency and more effective governance across the hedge fund sector in an attempt to pre-empt the requirement

212 For example, such managers are likely to be managing investments under Article 37 of the Regulated Activities Order, advising on investments under Article 53 of the Regulated Activities Order or managing an AIF under Article 51ZC of the Regulated Activities Order.

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

214 See, for example, FCA, Hedge Fund Survey, June 2015.

215 The CityUK, Hedge Funds, May 2013.

216 ibid.

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for greater regulation and legislative intervention.[217] Funds that adopt the Hedge Fund Standards are required to adhere to a 'comply or explain' regime, ensuring that certain information is disclosed to investors about how the standards have been complied with, or why certain requirements have otherwise not been met or are not appropriate in the context of a particular fund. As of August 2018, 130 hedge fund managers with combined assets under management of over US$1 trillion had committed to the Hedge Fund Standards.[218]

v Private equity

In the UK, private equity firms typically use limited partnerships as investment vehicles to take advantage of their tax-transparent nature and their lower disclosure requirements as compared with limited companies or LLPs. The limited partners in the partnership are typically the institutional investors in the private equity fund, while the private equity firm will usually act as the general partner and will therefore be responsible for the day-to-day management of the partnership's activities.

The UK is the largest and most developed private equity centre in Europe, second in size globally only to the US.[219] Fundraising in the private equity sphere has improved significantly in recent years, with 2017 being the fifth consecutive year in which private capital fundraising surpassed the US$300 billion mark.[220] Preqin, the alternative investment industry analyst, has noted that prices for assets have been at the forefront of investors' and fund managers' minds, although this did not affect the strong fundraising levels. A keynote address by Johannes Huth of KKR in the 2018 Preqin report noted that the UK's decision to leave the European Union unleashed considerable volatility in the sterling exchange rate, and the full consequences of this event are yet to play out, with one particular concern being that the UK has a substantial current account deficit, meaning it is more vulnerable to shocks as compared with the eurozone,[221] which currently still has a current account surplus.[222] However, the longer term impact of the UK's exit from the EU (along with any compounding effects caused by the covid-19 pandemic) on private equity fundraising and investment in the UK remains to be seen.

There have been some initiatives in recent years to improve the transparency of the private equity industry in the UK in order to address criticism that the activities of private equity funds are opaque and to counteract the perception that they are insufficiently regulated. In November 2007, the Walker Guidelines were introduced to encourage improved disclosure by private equity bodies.[223] These voluntary guidelines recommend that private

217 The SBAI, The Hedge Fund Standards (11/2015), 5 November 2015.
218 The SBAI, Annual Report 2018.
219 TheCityUK, UK Fund Management, April 2018.
220 Preqin, 2018 Preqin Global Private Equity & Venture Capital Report, 2018.
221 Preqin, 2018 Preqin Global Private Equity & Venture Capital Report, 2018.
222 Eurostat, EU current account surplus €59.9 bn, 6 July 2020. .
223 Sir David Walker, Guidelines for Disclosure and Transparency in Private Equity, November 2007.

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equity firms that meet certain specified criteria[224] should publish annual reviews or regular updates on their websites containing information about their investment approaches and portfolios. In addition, the Walker Guidelines state that private equity firms should provide various performance data on a confidential basis to an independent third party appointed by the British Private Equity and Venture Capital Association (BVCA) in an effort to encourage increased transparency about the overall private equity industry. As a result of a consultation by the Walker Guidelines Monitoring Group, the Walker Guidelines were amended in July 2014 to enhance the reporting requirements therein to include the information required by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.

In September 2009, the Institutional Limited Partners Association (ILPA) published its first set of private equity principles with the aim of encouraging improvements in private equity practice by furthering the relationship between general partners and limited partners for the long-term benefit of participants in the industry. A revised set of principles was subsequently released in January 2011 following feedback from industry participants.[225] The ILPA principles encourage a greater focus on transparency, governance, and the alignment of interests between private equity managers and their investors.

Traditionally, private equity has been a relatively lightly regulated area of asset management in the UK although, in common with other asset management entities, private equity firms have required FCA authorisation if they are undertaking regulated activities specified in the Regulated Activities Order. This relatively relaxed treatment changed, however, following the implementation of the AIFMD, as managers of private equity funds fall within the scope of the regime. The private equity industry has voiced concerns over the potential impact of the AIFMD on private equity activities.[226] The rules on remuneration are likely to have an impact on policies at private equity firms, particularly in relation to the requirements for deferred remuneration, and furthermore, the private equity provisions (intended to limit asset-stripping of companies) have the potential to interfere with some of the usual funding structures adopted by private equity funds, potentially restricting corporate reorganisations and targeted disposals of parts of a target company's business. As with the regulation of hedge funds, the FCA has recently indicated in its 'Dear CEO' letter of January 2020 to managers of alternative investment vehicles that it may also take future regulatory action in this sector.

224 Under the Walker Guidelines, a private equity firm is defined as 'a firm authorised by the FSA that is managing or advising funds that either own or control one or more UK companies or have a designated capability to engage in such investment activity in the future where the company or companies are covered by the enhanced reporting guidelines for portfolio companies'. In turn, a portfolio company is defined as 'A UK company (a) acquired by one or more private equity firms in a public to private transaction where the market capitalisation together with the premium for acquisition of control was in excess of £300 million, more than 50 per cent of revenues were generated in the UK and UK employees totalled in excess of 1,000 full-time equivalents; [or] (b) acquired by one or more private equity firms in a secondary or other non-market transaction where enterprise value at the time of the transaction is in excess of £500 million, more than 50 per cent of revenues were generated in the UK and UK employees totalled in excess of 1,000 full-time equivalents'.

225 ILPA, Private Equity Principles, version 2.0, January 2011, available at ilpa.org/ilpa-private-equity-principles.

226 See, for example, the statement by Simon Walker, Chief Executive of the BVCA, on the AIFMD on 26 October 2010, in which he referred to the AIFMD as a 'defective Directive', and argued that the EU had taken a 'hostile interest in the wrong industry at the wrong time and for the wrong reasons'.

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Managers of certain venture capital funds may currently benefit from the European Venture Capital Funds Regulation (VCF Regulation).[227] The VCF Regulation applies to managers of collective investment undertakings (other than UCITS schemes) that are established in the EU, are registered in their home Member State in accordance with the AIFMD and manage portfolios of qualifying venture capital funds. Generally, the VCF Regulation applies to managers of collective investment undertakings with assets under management that do not exceed €500 million in total. Such managers may use the European venture capital fund designation if they meet a number of conditions. The VCF Regulation introduces a marketing passport, which can be used to market funds with European venture capital status to EU investors, subject to complying with certain requirements. This allows managers of qualifying funds to benefit from cross-border marketing without having to comply with the full requirements of the AIFMD (for completeness, see Section II.iii for further details on how cross-border services between the UK and the EU are expected to operate following the end of the implementation period).

vi Other sectors

Sovereign wealth funds

While the UK does not operate a sovereign wealth fund (SWF) of its own, London remains a popular location for foreign SWFs to establish branches to pursue their investment activities, and the government has generally sought to encourage foreign direct investment into the UK.

There is no specific regulatory regime that applies to foreign investment by SWFs in the UK; instead, the position is regulated by general provisions in domestic and EU law that may permit review of proposed transactions in certain defined circumstances that are of general application. For example, an acquisition of UK assets is always liable to review under the merger control regimes established under the Enterprise Act 2002 or by the EC Merger Regulation[228] if there are concerns that the transaction would result in a significant reduction in competition in a particular market. It is also possible for the government to intervene in certain circumstances where the investment involves issues of special public interest – for example, where a transaction might have an adverse effect on media plurality by concentrating control of the supply of newspapers or provision of broadcasting.[229] Subject to the range of specific requirements, however, there is no other overriding rule that requires approval for foreign direct investment in the UK.

Exchange-traded funds

Exchange-traded funds (ETFs) are traditionally passively managed open-ended funds that are listed and traded on a stock exchange. The fund's trading price is linked to the net asset value of the underlying assets, and typically tracks the performance of an index such as the FTSE 100. The key characteristics of an ETF are that it is tradeable, and that it offers simple exposure to a more complex underlying asset or index. ETFs are popular with investors as they have lower operating expenses than actively managed funds and a transparent structure (as a listed company), and are tax-efficient. In the UK, ETFs are OEICs.

227 Regulation 345/2013.

228 Regulation (EU) No. 139/2004.

229 Section 59 Enterprise Act 2002.

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ETFs have performed well in recent years, venturing into emerging markets, real estate, infrastructure, private equity and hedge funds, such that global assets under management of ETFs have been reported to have grown to about US$6.35 trillion in the as of the beginning of 2020.[230] Following a Federation of Small Businesses report on ETFs in April 2011, which highlighted the potential risks of the rapid increase in value of the ETF industry, European regulators have begun to focus attention on these structures. ESMA published revised consolidated guidelines on ETFs and other UCITS-related issues in August 2014, and an updated questions and answers paper on ETFs and other UCITS-related issues in February 2016. The FCA has incorporated ESMA's guidelines into the COLL Sourcebook.

Venture capital trusts

The venture capital trusts (VCTs) scheme was introduced in the UK in April 1995 as a means of encouraging individual investors to support higher-risk unlisted start-up companies through providing certain reliefs for such investors from UK income and capital gains tax. VCTs, like investment trusts, are not trusts, but companies that are admitted to trading on a regulated market in the EU. They invest in securities issued by small unquoted[231] trading companies for which there is no liquid market. VCTs help mitigate this investment risk for investors by spreading their investments across a range of such companies, and by providing liquidity through the VCT's own listed shares to overcome the illiquidity of its underlying assets. To be treated as a VCT, a company must meet a number of detailed conditions and be approved as such by HMRC.

VII TAX LAW

i Taxation at the level of the investment vehicle

Taxation of domestic funds

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

230 ETFGI, ETFGI reports assets in the global ETFs and ETPs industry which will turn 30 years old in March started the new decade with a record 6.35 trillion US dollars, 16 January 2020.

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

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Type of vehicle	Taxation of income	Taxation of realised capital gains
Investment trust	Dividend income generally exempt Non-dividend income generally taxable at 19 per cent Distributions to investors tax deductible (to the extent made up of interest income) if an election is made	Exempt
Authorised investment funds (OEIC/AUT)	Dividend income generally exempt Non-dividend income generally taxable at 20 per cent Distributions to investors tax deductible (to the extent made up of interest income) if more than 60 per cent of the vehicle's investments are debt instruments or similar investments	Exempt
PAIF	Income from real estate investment exempt Deduction for PAIF distributions (interest) means that a PAIF can normally be managed so that no corporation tax is payable on other income Otherwise, distributions to investors not tax deductible	Gains from real estate investment exempt
REIT	Dividend income generally exempt Income from real estate investment exempt All other income taxable at 19 per cent Distributions to investors not tax deductible	Gains from real estate investment exempt Gains from other investments taxable at 19 per cent
Exempt UUT	Typically no tax payable: whilst income is taxable at 20 per cent, all income is deemed to be distributed to investors annually and that distribution is treated as tax deductible	Exempt
Non-exempt UUT	Dividend income generally exempt Non-dividend income taxable at 19 per cent Distributions to investors not tax deductible	Gains taxed at 19 per cent
VCTs	Dividend income generally exempt Non-dividend income generally taxable at 19 per cent Distributions to investors not tax deductible	Exempt
ACS (co-ownership or limited partnership schemes)	Co-ownership and limited partnership schemes are fiscally transparent. (Investors are treated as directly receiving a share of income subject to the scheme)	Limited partnership schemes are fiscally transparent. (Investors are treated as owning a share of the assets subject to the scheme.) While not fiscally transparent, co-ownership schemes are not subject to UK tax on capital gains. (Investors are treated as owning interests in the scheme rather than a share of the assets subject to the scheme.)
Limited partnership	As for ACS	As for ACS (limited partnership scheme)
Limited liability partnership	As for ACS	As for ACS (limited partnership scheme)

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Taxation of foreign funds

Subject to certain exceptions (some of which are highlighted below), a foreign fund would not be subject to UK tax unless it carries on a trade in the UK, and a foreign fund will not be treated as carrying on a trade in the UK merely by virtue of engaging an independent investment manager in the UK to carry out transactions on its behalf, provided that certain conditions as to the manager's activities, relationship with the foreign fund and remuneration are met.[232]

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

a withholding taxes on UK-source payments, such as payments of annual interest, royalties and rent. The UK does not, however, impose any withholding tax on the payment of dividends;

b stamp taxes on the transfer of shares, certain other marketable securities and UK real estate; and

c taxes on income from a UK property business and taxes on gains from the disposal of UK real estate under a new regime enacted as part of the Finance Act 2019 (new NRCGT regime). With effect from April 2019, foreign funds may be liable to UK tax on any gain realised on the disposal of UK real estate or in a UK real estate rich company. The manner in which the new NRCGT regime applies would depend on the structure of the foreign fund. In addition, certain elections may be available under the new NRCGT regime to modify the default tax treatment of the fund as well as the investors.

ii Taxation at the level of the investor

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

Taxation of investors in domestic funds

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

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

232 Sections 1142 and 1146 Corporation Tax Act 2010. See also HMRC Statement of Practice 1 (2001) (as amended).

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

Foreign investors investing in UK real estate

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

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

VIII OUTLOOK

i Brexit and the implementation period

Brexit and its potential impact on the UK financial sector continues to be a key topic of discussion. Though it has been four years since the EU referendum, and despite the formal withdrawal of the UK from the EU on 31 January 2020, both parties have yet to agree on the shape of their future relationship. The fifth round of formal talks concluded in July 2020 with no evident progress on the deadlock on the question of the 'level playing field' or access to British fishing waters. There, therefore, remains considerable uncertainty about whether the UK and the EU will reach agreement on the withdrawal agreement (by the end of the implementation period in December 2020) and, thereafter, the extent to which Brexit will be 'hard' or 'soft'. Asset managers have generally already implemented their contingency plans, but the IA, in a manifesto published in November 2019, has stressed that a no-deal exit would be the 'worst possible outcome for UK investment managers' particularly given the loss of passporting rights, calling for a future relationship with the EU 'underpinned by

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regulatory co-operation'.[233] At the same time, the IA has also argued that given that the UK would not have 'a meaningful role in shaping' rules in nascent sectors such as fintech and sustainable investment, it should be free to diverge in its regulatory direction in these areas.

Statements made by ESMA in July 2017 raised doubts about the continuing viability post-Brexit of the 'delegation model' employed by many international fund management groups, in which a fund manager authorised in one country delegates fund management or advisory duties to an affiliate in another jurisdiction (which may be outside the EU).[234] More recently, however, the Chair of ESMA, Steven Maijoor, noted that ESMA is not seeking to undermine or put in doubt the delegation model. ESMA acknowledges that the delegation model is a key feature of the investment funds industry that has contributed to the success of the industry by providing the requisite flexibility to organise centres of excellence in different jurisdictions. ESMA has sought to clarify that it does not envisage changing the legal requirements, but is rather seeking to aid their practical application and help authorities when supervising delegation arrangements so that national regulators would be able to interpret the requirements consistently.[235] In support of this, ESMA signed a memorandum of understanding (MOU) with the FCA in February 2019 ensuring that asset managers would continue to be able to employ the delegation model in a scenario where the UK leaves the EU without a deal. The FCA, ESMA, and EU national securities regulators issued a statement in July 2020 confirming that these MoUs remain relevant and appropriate, and will come into effect at the end of the implementation period.

ii Senior managers and certification regime

In December 2019, the SMCR, which previously covered banking firms, and to a more limited extent insurers, was extended to bring all FCA solo-regulated firms within scope, including asset managers. However, as set out in Section V.v, there are a number of requirements that firms have until March 2021 to comply with.

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

The regime requires all firms to identify:

a their senior manager functions (SMFs) and prepare SMF statements of responsibilities;

b employees within the certification regime, and, for 'enhanced' firms, prepare 'responsibilities maps' setting out the firm's management and governance arrangements; and

c SMF handover procedures.

233 The IA, A manifesto for investment management: plans to power the economy, November 2019.

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

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

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

iii Regulatory scrutiny

In its business plan for 2020 to 2021, the FCA identified certain priority themes. The areas that are of particular significance to the asset management industry are:

a investment management (including assessing the impact of remedies implemented following the Asset Management Market Study, and assessing asset managers' compliance with the SMCR and the transition away from LIBOR);

b retail investment (including ensuring investment products are appropriate for consumer needs, a consumer harm campaign to help consumers make better choices about retail investments, and strengthening regulatory standards applicable to firms and the network of individuals operating in them);

c climate change (including continuing policy research into retail investment product design and hosting the CFRF);

d operational resilience (including requirements on firms to take ownership of their operational resilience, put in place contingency plans and to prioritise plans and investments based on their public interest impact);

e wholesale financial markets (including the replacement of LIBOR, and enhancing governance and accountability through the SMCR); and

f its continuing work on the post-Brexit regulatory regime.

One of the most significant regulatory changes is the plan to transition from LIBOR by the end of 2021, which was announced by the FCA in 2017.[236] Sterling LIBOR will be replaced by a benchmark administered by the Bank of England known as the Sterling Overnight Index Average (SONIA). The FCA and the PRA published a joint statement in June 2019 outlining eight examples of desirable transition planning that are of relevance to all firms, including asset managers.[237]

The Fifth Anti-Money Laundering Directive (5MLD) was transposed into UK law in January 2020. There are a number of changes that are of relevance including: explicit customer due diligence requirements to understand control structure of corporate customers; requirements to identify CEOs and chief executives; and requirements to establish the source of funds for individuals and business based in high-risk third countries.[238]

236 FCA, The future of LIBOR (Speech by Andrew Bailey, Chief Executive of the FCA, at Bloomberg London), 27 July 2017.

237 FCA, Feedback on the Dear CEO letter on LIBOR transition, June 2019.

238 5MLD was transposed into UK through the Money Laundering and Terrorist Financing (Amendment) Regulations 2019.

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iv Review of tax regime

In March 2020, the UK government announced its intention to conduct a review of the UK funds regime that 'will consider taxation and relevant areas of regulation to ensure the ongoing competitiveness and sustainability of the UK regime'.[239] One of the first steps in this review was the publication of a consultation on how the UK could be made more attractive as a location for alternative investment funds to establish asset holding companies (AHCs). While the industry has been asked to comment on how the UK's tax system could be changed to achieve this, the consultation suggests that the UK government may be slow to make any changes, unless it can be shown that the associated benefits outweigh costs and risks.

Another step will be to review the value added tax treatment of fund management fees. It is possible that this review may end up falling within the ambit of an industry working group which the UK government announced in March 2020 would be created to examine VAT on financial services more generally.[240] In other VAT developments, the UK's VAT exemption for the management of special investment funds[241] has been broadened, in particular, to include the management of certain pension funds.[242] It is also possible that the recovery of input VAT attributable to the supply of certain financial and insurance services to EU customers will be permitted after 2020; a statutory instrument to this effect has been made, but it has not yet been brought into force.[243]

v Covid-19

The covid-19 pandemic has resulted in unprecedented disruption to both the real economy and the financial markets, the full extent of which is not yet known and likely will not be for some time to come. However, unlike the 2008 global financial crisis, this crisis is not the result of asset quality or credit concerns and, despite initial spikes in market volatility, the FCA has indicated that the markets have substantially continued to operate in an orderly manner.[244]

The ESMA stress test in 2019 suggested that 40 per cent of high yield bond funds would not have sufficient liquid assets to meet redemption requests following a severe shock. The covid-19 pandemic has manifested just such a shock. In fact, the most significant challenge faced by asset management, as was the case in the aftermath of the Brexit referendum, will be a fund's ability to manage liquidity, especially when confronted with a higher volume of redemption requests as investors seek to cut losses and preserve, or indeed increase, their

239 HM Treasury, Paragraph 1.5 of the consultation on the 'Tax treatment of asset holding companies in alternative fund structures', 11 March 2020, available at the following link: https://www.gov.uk/government/consultations/tax-treatment-of-asset-holding-companies-in-alternative-fund-structures.

240 HM Treasury, Paragraph 2.239 of the Budget 2020 Red Book, 11 March 2020, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/871799/Budget_2020_Web_Accessible_Complete.pdf.

241 This exemption is covered in more detail from an EU perspective in Section XIV.v of the European Overview chapter.

242 The Value Added Tax (Finance) Order 2020 (SI 2020/209).

243 Value Added Tax (Input Tax) (Specified Supplies) (EU Exit) (No. 2) Regulations 2019 (SI 2019/408).

244 FCA, Statement on UK markets, 23 March 2020.

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cash holdings. The FCA has indicated its intention in the wake of the pandemic to focus on ensuring that redemption arrangements are in the interests of both those remaining in the fund and those wishing to exit.[245]

Additionally, funds with a focus on illiquid underlying assets, for example property funds, are challenged by valuation uncertainty in the face of covid-19. The combination of sharp falls across many asset classes paired with an increase in investor redemptions has seen some funds having to suspend redemptions. The FCA has recognised that suspensions may, in these circumstances, be appropriate to protect the interests of investors, provided they are implemented in accordance with applicable regulator obligations. In a distressed market, such as the one spurred on by covid-19, funds are likely to face difficult choices between suspension to preserve value for remaining investors or selling in a distressed market to meet an increasing demand for redemption.

245 FCA, The role of investment managers in the post Covid-19 recovery (Speech by Christopher Woolard, Interim Chief Executive at the FCA, delivered at a webinar hosted by The Investment Association), 8 July 2020.

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Appendix 1

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

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