EXPLANATORY MEMORANDUM TO

THE COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES (CONTRACTUAL SCHEME) REGULATIONS 2013

2013 No.

1. Introduction

1.1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1. This instrument creates a new fund vehicle for the UK investment management industry to make UK domiciled funds for collective investment in transferable securities more competitive. After extensive consultation the contractual scheme comes in two forms and allows tax to be paid only once by the investor, rather than by the fund itself. It will also allow the UK to take advantage of trends within the industry to merge and consolidate funds.

2.2. Collective investment schemes allow investors to receive profits and income arising from the holding, management or disposal of assets. A contractual scheme will be tax transparent. This means that for direct tax purposes income and capital gains will accrue to investors directly as they arise, as if investors had invested directly in the assets rather than in units of the scheme. The scheme is not subject to corporation tax, income tax or capital gains tax (returns instead being taxed in the hands of investors).

2.3. Collective investment authorised by the FCA is carried on at present through unit trusts or an open-ended investment company, neither of which are tax transparent structures for collective investment.

2.4. A contractual scheme may be a co-ownership scheme, which has no legal personality separate from that of its investors, or a limited partnership formed under the Limited Partnership Act 1907 (a partnership scheme). Similar schemes are available already in some other EU member States.

2.5. A contractual scheme is to be authorised and supervised by the Financial Conduct Authority (“the FCA”) under provisions inserted by the instrument in Part 17 of the Financial Services and Markets Act 2000 (“FSMA”).

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1. None

4. Legislative context

4.1. Article 1.3 of the Directive of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions

relating to undertakings for collective investment in transferable securities (No. 2009/65/EC)[1] ("UCITS IV") confers a right to constitute UCITS in accordance with contract law (as common funds managed by management companies).

4.2. UCITS IV was implemented by the Undertakings for Collective Investment in Transferable Securities Regulations 2011 (S.I. 2011/1613) and by rules made by the Financial Services Authority under Part 17 of FSMA. This instrument is to be made under section 2(2)(b) of the European Communities Act 1972 to provide for the formation of UCITS in accordance with contract law as a matter that is related to the right conferred by Article 1.3.

4.3. The instrument inserts a new Chapter 3A in Part 17 of FSMA to govern the authorisation and supervision of contractual schemes by the FCA. It extends to contractual schemes the FCA's power to make rules for this purpose in relation to unit trusts. FSMA has been amended by the Financial Services Act 2012, and this instrument takes account of all relevant amendments.

4.4. Other primary and secondary legislation is amended to provide for contractual schemes broadly in line with provisions already made for unit trusts and open-ended investment companies. In particular, the operator and depositary of a contractual scheme will be subject to the authorisation requirements in Part 4A of FSMA.

4.5. The Limited Partnerships Act 1907 partly governs limited partnerships and is modified for the operation of partnership schemes. The Insolvency Act 1986 and insolvency rules and equivalent legislation for Northern Ireland are modified to enable co-ownership schemes to be wound up in the event of insolvency.

5. Territorial Extent and Application

5.1. The instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1. The Financial Secretary to the Treasury, the Rt Hon Greg Clark MP, has made the following statement regarding Human Rights:

> In my view the provisions of the Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013 are compatible with the Convention rights.

7. Policy Background

7.1. The Government has worked closely with industry in order to introduce authorised tax transparent funds in the UK. The overriding aim is to enhance the competitiveness of the UK's asset management industry by ensuring that the UK can authorise schemes of this sort in line with leading European

[1] OJ No. L 302, 17.11.2009, p.32.

competitors. The UK is the largest asset management centre in Europe and this measure gives investors a greater choice of suitable investment vehicles. The introduction of these funds will ensure the UK is able to compete effectively as a domicile for a significant share of funds managed in Europe.

7.2. More than 70% of the net value of European funds for collective investment in transferable securities is governed by EU Directives on Undertakings for Collective Investment in Transferable Securities ("UCITS") of which the UK has a 12% market share. The legislation will enable contractual schemes to be used for UCITS, but also, to maintain uniformity in the market for fund management, for NURS (non-UCITS schemes for retail investors) and QIS (qualified investor schemes).

7.3. The funds will benefit investors wishing to pool funds across borders into single vehicles authorised under UCITS and in the future, the Alternative Investment Fund Managers Directive (AIFMD).

7.4. The leading fund domiciles within the European Union, Ireland and Luxembourg, already offer tax transparent schemes. Other major EU jurisdictions are reviewing legislation for collective investment and the case for introducing tax transparent fund structures. The UK contractual schemes will not only compete in this market, but have been designed in consultation with professional bodies and practitioners to solve problems identified through their experience of operating such funds offshore.

7.5. The choice of the UK as a domicile for a greater share of the European market in collective investment will help to reinforce the UK's reputation as a 'pro-business' international financial centre.

7.6. The UK is also in a good position to compete in this market, if it makes provision for a tax transparent fund structure, because its authorised collective investment schemes are supervised under a regulatory regime which is widely recognised (even before the changes brought about by the Financial Services Act 2012) to be robust and to offer effective safeguards for investors.

7.7. Limited partnerships are widely recognised in countries in and outside the EEA to be tax transparent. The co-ownership scheme has been designed to meet recognised international criteria for tax transparency and ensure as far as possible that foreign jurisdictions are likely to accept that it is tax transparent.

7.8. By investing in a tax transparent fund UK institutional investors with tax-exempt status, such as pension funds, will benefit from more appropriate rates of foreign withholding tax. The investor, rather than an opaque fund in which the investor holds units, is the relevant entity for determining the amount of tax that should be withheld.

7.9. An authorised collective investment scheme falls into one of three categories of strategy for investment in transferable securities. A UCITS, being established and regulated in accordance with the UCITS Directives, may be promoted in any EEA State. A NURS and a QIS may be promoted to the public in the UK

and in any other State which allows them to be promoted. A QIS may only be promoted to qualified investors. The managers of these schemes will generally be authorised under AIFMD when it is transposed into UK law which will safeguard investors.

7.10. It is essential to make a tax transparent structure available for authorisation without creating a distinct regime for UCITS, in order to maintain uniformity of law and practice in the market for collective investment and avoid market distortion (e.g. by ensuring that schemes with different investment strategies are subject to the same tax treatment).

7.11. Chapter VIII of UCITS IV allows fund managers to pool the assets of UCITS ("feeder funds") domiciled in different jurisdictions in a master fund. In order to be effective and attractive to investors, a master fund needs to be tax transparent, so that investors can avoid the complicated tax and reporting requirements that can result from cross border investment in opaque funds.

7.12. Evidence shows that the availability in the UK of a tax transparent structure will be of particular interest to promoters of UCITS master funds. But the same economic and tax benefits are also likely to stimulate the establishment in the UK of stand-alone UCITS (not master funds), NURS and QIS.

7.13. Wider economic benefits include improving the competitiveness of the UK as a domicile of choice for investors. More extensive pooling of assets in a tax-transparent fund will allow lower management fees and administration costs, greater investment diversity and higher returns. Investors will be able to benefit in these ways without having to invest in a fund that is domiciled outside the UK.

7.14. Contractual schemes are expected to be subject to complex reporting requirements which are likely to be unsuitable for ordinary retail investors. There is also a remote possibility of an investor being held to be liable in a foreign court for debts in excess of the value of their units. Both schemes therefore require an initial minimum investment of £1m to deter investment by retail investors who have not sought professional advice and do not possess the experience, knowledge and expertise necessary to appreciate the risks.

8. Consultation outcome

8.1. The Government published a consultation paper in January 2012 and consulted on an ongoing basis during the course of that year. There were 20 written responses, including 6 from industry bodies and 12 from major UK fund managers, depositories and professional advisers (including law firms, tax specialists, the Law Society and individuals in a private capacity).

8.2. Officials put arrangements in place, before and after the main consultation, for regular working groups to meet to explore the technical provisions for contractual schemes and the policy implications. The Government published revised draft Regulations at the end of July 2012 and invited further written

comments. Officials also presented the proposals at an Open Session attended by approximately 100 interested stakeholders.

8.3. The Government has worked extensively with the FCA and its General Counsel Division, specialists in tax and fund regulation (including the Investment Management Association), insolvency practitioners, law firms and (where appropriate) other Government Departments. The outcome of discussion with stakeholders and other experts and of consideration of consultation responses has been set out in a consultation response paper published in April 2013.

8.4. The view taken by representatives of the UK asset management industry is that the proposals will allow the UK to capitalise on the opportunities offered by UCITS IV, particularly in relation to setting up master funds. It will encourage UCITS master funds to be based here, in Europe's pre-eminent asset management centre, while investors across Europe will benefit from UK-based feeder funds.

8.5. The consultation response sets out how the Government has accommodated feedback in relation to partnership schemes, investor protection safeguards, transferability of units, insolvency provisions and aspects of tax provisions. These were necessary in order to ensure the schemes were commercially workable and attractive to investors.

Key Issues Addressed through the Consultation

8.6. The limited partnership model would have been unsuitable for partnership funds without modification. There was a particular risk highlighted where an authorised operator of a number of funds could be subject to unlimited liability provisions when acting as the General Partner of a Tax Transparent Partnership Fund. The Government has therefore modified the Limited Partnership legislation and this is set out in full in the formal consultation response.

8.7. The original consultation proposed that the Regulations prohibit the transfer of units except where permitted by FCA rules. The Government has since concluded that a blanket restriction on transfers would be disproportionate and that any restrictions upon transferability should be decided by the promoters and set out in the deed of the scheme. This is subject to the minimum investment limits set out in the formal consultation response.

8.8. Following consultation, the Government has legislated to ensure certainty in both the solvent and insolvent winding-up of both partnership and co-ownership tax transparent funds. Insolvency provisions in relation to insolvent co-ownership schemes can be found in the final regulations.

9. Guidance

9.1. This instrument makes provision for the FCA to make rules about the formation and operation of authorised contractual schemes. Once the FCA has formally

made the required rules, then it will publish a policy statement and guidance on its website.

10. Impact

10.1. Regulation is necessary in order to ensure the schemes are operated in a responsible and appropriate manner. However, there was consensus during the consultation that there are no mandatory costs for industry. A decision to launch a tax transparent fund will be made on a purely commercial basis. Fund managers and depositaries will incur costs on setting up schemes and operating them in compliance with the legislation (including FCA rules).

10.2. The FCA will incur transitional costs in making relevant changes to its rules, but this is assumed to be achieved through existing resource and therefore there is no monetised transitional cast for the FCA.

10.3. An Impact Assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum.

11. Regulating Small Business

11.1. There was a consensus among respondents to consultation that micro-businesses would be disadvantaged if they were exempted from the scope of the legislation. A fund manager may be a micro-business. An exemption would not be a safeguard against the burden of regulation, but would deprive micro-businesses of the opportunity to run tax transparent funds. This would be discriminatory and not within the purpose of exemptions for small business.

12. Monitoring and review

12.1. The instrument requires the Treasury to review its operation and effect and publish a report within five years of its coming into force and every five years after that. Following a review it will fall to the Treasury to consider whether the Regulations have achieved the objectives of the regulatory system applied to contractual schemes and whether they remain appropriate or could be achieved with less regulation.

12.2. The take-up of authorised contractual schemes will be subject to ongoing review. The impact assessment sets out expected take-up of tax transparent funds. Progress will be evaluated against measurable outcomes set out in the impact assessment for achievement over a period of 10 years, namely:

- £180bn of assets in UK managed funds would not be domiciled offshore;
- £190bn of additional assets for UK managed funds transferred from overseas;
- £190bn in additional assets domiciled in the UK by non-UK fund managers;
- a significant increase in additional fund management activity in the UK. management activity in the UK

13. Contact

13.1. Matthew Cornford at HM Treasury: Tel 020 7270 1041 or e-mail: matthew.cornford@hmtreasury.gsi.gov.uk can answer any queries regarding this instrument.