Keeping up with Alternative Investment Funds

February 2022

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Introduction

Welcome to our February edition of Keeping up with Alternative Investment Funds.

Our newsletter this month includes articles on Transfer Pricing, and HMRC's current approach with regards to asset managers. This is something which is being seen regularly in the market at the moment, and making sure your TP arrangements are up to date and compliant is something we would wholeheartedly recommend.

We are also talking about the opening up of Private Equity to retail investors. This is a hot topic from a UK government point of view, and several PE fund managers look keen.

There is an update on the new Luxembourg securitisation law, which will be of interest for those of you using Luxembourg securitisation vehicles for your debt. This looks to be a more flexible regime than before, which is generally positive.

Finally, we have an article on Equity Events for fund managers. Many of you will have gone though or be soon to go through generational changes in your business. This is something we often help with in order to deliver a tax efficient solution as people exit the business.

We would also like to take the opportunity to announce the events that our team will be hosting in the upcoming months.

PwC Alternative Investment Funds Annual Conference - Wednesday 27 April 2022

We are delighted to announce that we are hosting our second Alternative Investment Funds annual conference on Wednesday 27 April from 1:30pm. It will be a half day in-person event which will be held at our More London office. This conference will focus on a broad spectrum of issues arising for asset managers who provide alternative investment solutions to their clients ranging across private equity, private credit, hedge funds, liquid trading / crypto assets, infrastructure and real estate investing. The afternoon will feature a plenary session, panel discussions and elective deep dive breakout sessions from a mixture of speakers. In addition, we will be showcasing industry focused digital solutions during the breakout and networking sessions. After the conference, you will get a chance to network with industry colleagues and PwC's Alternative Investment Funds team over drinks and canapés. Please register here. For queries, please email uk_alternative_investment_funds@pwc.com.

Please do continue to reach out to your usual PwC contacts if you would like to discuss any of the above, and please do share your feedback with us if there is a particular topic or issue you would like us to cover in the future.

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HMRC's Transfer Pricing Audit Activity and Profit Diversion Compliance Facility

In brief

We continue to see a high level of HMRC interest in the alternative asset management industry. The taxpayers in the financial services industry have received 'nudge' letters under HMRC's Profit Diversion Compliance Facility ('PDCF').

HMRC now has a well established evidence based approach to investigations and relies on primary evidence to support representations regarding the 'facts on the ground'. HMRC's focus on primary evidence is expected to continue and is reflected in their intention to legislate the requirement for a summary audit trail as part of the upcoming mandatory UK transfer pricing documentation rules.

HMRC's evidence based approach puts considerable emphasis on contemporaneous materials such as emails, professional advice received, evidence on the various interactions during an investment process (which is sometimes not formalised), board or committee meeting minutes and intra-group contracts, but also detailed analysis of people, location and roles, as well as a forensic approach to costs and cost allocations.

In detail

Transfer pricing audits

In recent years HMRC has adopted a more forensic, investigative approach to transfer pricing audits with a focus on obtaining primary evidence to support the underlying assumptions upon which the transfer pricing policies and documentation have relied. It is common practice for taxpayers to receive numerous extensive requests from HMRC for documentation and information, frequently including emails, board or committee meeting minutes, proof of decision making, etc., in order for HMRC to test the transfer pricing position.

We have observed that HMRC's understanding of the asset management industry has increased significantly and they are using this sector specific knowledge to challenge differences they are seeing across value chains in certain strategies or business lines, as well as to dig deeper into understanding the activities performed at each stage of the investment lifecycle.

Areas of focus / themes that we have identified in recent transfer pricing audits in the asset management industry include:

- A focus by HMRC on details of the transfer pricing review framework in place, including a focus on how the governance process deals with flagging and appropriately pricing any new or one-off inter-company arrangements. We think that this will become an increasingly important area of focus and is likely to be closely linked with our observations of HMRC's increased pursuit of penalties.
- We have also observed it become more common for HMRC to ask, informally at least, for documents and information that may not be within the power and possession of the UK taxpayer, and they are challenging with greater frequency than we have previously seen, any defence relying on power and possession arguments.
- Necessity of a double sided transfer pricing analysis. HMRC are increasingly interested in understanding the activities undertaken offshore, in order to evaluate the reasonableness of the onshore transfer pricing results.
- HMRC has successfully challenged, in detail, management service charges. For example, does the cost base include all relevant individuals? Is the cost base appropriate? This is often seen by taxpayers as a 'standard' or 'less complex' aspect of transfer pricing policies and as such may not receive the same regular level of review or analysis as the more complex material transfer pricing policies.
- Implementation of transfer pricing policies continues to be a focus area for HMRC enquiries. This aligns with our experience of accurate implementation often being a key challenge for taxpayers.
- Most recently we have seen HMRC explore the topic of staff / partner co-investment in the funds, including whether such arrangements fall within the scope of TP rules and whether they constitute arm's length arrangements.
- Allocation keys within profit split models are also subject to increased scrutiny by HMRC, particularly where there is an element of judgement related to value contribution embedded in the allocation key.

HMRC's Transfer Pricing Audit Activity and Profit Diversion Compliance Facility (continued)

HMRC's profit diversion compliance facility: our experiences to date

The PDCF was launched back in 2019 to encourage businesses not already under enquiry to review their international tax positions (most commonly focussed on transfer pricing) and produce a disclosure report and proposal to address any perceived high-risk positions taken. The PDCF underscores HMRC's increased priority on addressing transactions that HMRC sees as potentially diverting profits away from the UK to low-tax jurisdictions.

Since inception there have been five tranches of 'nudge' letters issued by HMRC suggesting that the taxpayer review their arrangements and consider registering for the PDCF. We expect further tranches of 'nudge' letters throughout 2022. A number of asset managers have received 'nudge' letters, registered for the Facility and have now concluded the process with HMRC.

We have pulled together a summary of key points from our experience of the PDCF after three years and five tranches of 'nudge' letters:

- Registration and pre-submission meetings are constructive and well received by businesses.
- In the majority of cases, the tax risks identified by businesses and the work plan presented at the pre-submission meeting are fully accepted by HMRC.
- HMRC has accepted the majority of final disclosure reports submitted with few or no amendments.
- Where there has been a difference in views, our clients have been given the opportunity to revisit the issue and gather further evidence in order to reach a satisfactory outcome.
- Outcomes on cases concluded so far are in line with HMRC's expectations in terms of additional tax paid although some 'nil adjustment' cases have been accepted.

Whilst a number of taxpayers have achieved acceptable outcomes under the PDCF and can take some comfort in the robustness of their transfer pricing policies and process going forward, the PDCF process, although much shorter than an investigation, is intensive, often resource-heavy and requires a high level of openness with what may be sensitive data.

Feedback from HMRC continues to be that they are happy to discuss entering into the Facility voluntarily, that is without a taxpayer receiving a nudge letter, provided that the taxpayer is not already under enquiry.

Disputes risk profiling tool

In light of the increasing number of transfer pricing disputes we are observing, PwC's Tax Disputes, Technology and Transfer Pricing teams have worked together to create a tool that uses data to identify potential areas of transfer pricing risk. The tool uses Country-by-Country Reporting data (where available) and publicly available data to create visualisations which allow us to identify likely areas of focus by HMRC. The tool also allows us to place a business within its industry peer group, to see how it may compare to its peers in terms of risk.

The risk profiling tool can help you to identify areas of potential risk, or areas where a revenue authority may perceive risk. This can provide you with helpful information to proactively manage these perceived risks as well as broader revenue authority relationships.

For more information on any of these issues, or for a deeper dive discussion on your particular circumstances, contact your usual PwC contact or one of our transfer pricing specialists listed below.

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The Retailisation of Private Equity

The Trend

Large institutional investors have traditionally dominated the private equity (PE) fundraising market. But in recent years, fund managers have started tapping into a relatively under-exploited retail investor market. The key drivers behind this retailisation trend are threefold:

- Retail investors represent an enormous pool of capital.
- Expanding their offering to retail investors allows fund managers to diversify their investor base.
- Retail investors may subject the sponsors to a lesser degree of downward fee pressure than their institutional counterparts.

However, it will take time for the momentum to build, and the PE industry does not expect a rapid increase in the amount of retail investment into PE funds over the short term. In a recent fund manager survey conducted by Preqin, 65% of respondents expect the amount of AUM generated by retail investment to stay the same or get smaller between 2020 and 2025, whilst 35% of respondents expect an increase.

Commercial Challenges

Opening the door to retail investment can involve some significant commercial challenges for PE fund sponsors, including:

- Alterations to familiar traditional PE fund structures and commercial terms in order to improve market accessibility; e.g. lowering minimum investment size; creating a semi-liquid or open-ended structure.
- Putting in place new distribution channels; e.g. enlisting banks and investment firms with an existing broad retail client base.
- Review of and enhancements to internal liquidity management procedures, in particular to mitigate the heightened risk that retail investors will default on their capital commitments.
- Navigating operational complexity and administrative burdens; e.g. increased investor communications and compliance (such as enhanced due diligence processes).

Legal Challenges

There are also a number of legal and regulatory challenges that may influence a fund sponsor's' ultimate decision whether or not to offer their product to a wider retail investor base, a few of which are highlighted below:

- If a sponsor intends to target retail investors in the EEA and the UK, the Packaged Retail and Insurance based Investment Products Regulations (PRIIPs) require the fund to produce a key information document (KID). The KID is a standardised document that must be produced to the required regulatory standard and set out simulated performance scenarios for retail investors. Fund managers typically will use a specialist third party to help them prepare a KID and confirm the risk/return profile of their fund product - this process will need to be factored into the overall budget and timeline to fund launch/closing where retail investors are being targeted. The introduction of the KID in 2018 has been met with some controversy in the marketplace, and although KID's have been produced in the PE space, many fund managers consider them to be potentially misleading to investors. It's also worth noting that from 1 July 2022, the extended PRIIPs regulation will bring into force some significant changes for manufacturers and distributors of packaged retail and insurance based investment products. In particular, the new regulations will (i) bring changes to calculation methods which will impact the computation of risks, performance scenarios, and transaction costs and (ii) require existing KID production systems to be reviewed, analysed for gaps, modified, and tested in advance of 1 July this year.
- A fund manager accepting retail money should be prepared for close scrutiny by the relevant supervisory authorities. They must consider whether they have the appropriate regulatory licences in place to admit retail investors, and licensing rules vary across Europe so this creates an additional layer of complexity. A regulated fund manager will also have to consider whether it has the appropriate infrastructure and resources in place to target and manage retail money safely and in accordance with the high-level regulatory rules applicable to it.

The Retailisation of Private Equity (continued)

Legal challenges (continued)

- The FCA remains focussed on consumer protections and distribution rules:
  - The Retail Distribution Review Rules (RDRs), which came into force in 2012, are aimed at improving consumer outcomes from financial advice and guidance, for example by banning commissions and raising adviser professional standards. A recent RDR review has highlighted the potential for more tailored guidance and simpler advice services to help attract more consumers towards support in purchasing investment products.
  - The FCA has also restated its commitment to consumer protection more generally with its announcement of a new consumer protection duty. This duty impacts all firms providing services to retail consumers. The new principle will require firms to deliver good outcomes for consumers and it will be based on four cross-cutting rules requiring businesses to: (i) act in good faith towards retail consumers, (ii) avoid causing foreseeable harm to retail consumers and (iii) enable and support retail consumers to pursue their financial objectives.
- When it comes to the marketing and distribution of private fund products, although the government is (to a certain degree) in support of expanding the offering of alternatives products to retail investors, the current UK regulatory framework contains a number of significant restrictions that impact a fund sponsor's ability to promote its investment products to retail investors. Although retail clients can in theory "opt up" to request treatment as professional clients, they can only do so if they are able to meet relatively restrictive qualitative and quantitative tests. It remains unclear whether these conditions will be relaxed in the future in order to further support retail investor access to alternatives products. The FCA is also currently consulting on strengthening the financial promotion rules for high risk investments, including crypto assets.

Tax Structuring Challenges

Finally, there are a number of structural and tax considerations to keep in mind when targeting retail investment into alternative funds.

It's very likely that managers raising money from retail investors will need to offer one or more separate fund sleeves through which these investors can participate. Given the nature of the target investor base, it may be harder to sell traditional alternative fund vehicles (such as say, the Luxembourg SCSp) and managers may find that in choosing the sleeve vehicle there is a greater need to cater for specific investor preferences in target jurisdictions then there would be when marketing to institutional investors.

This may mean that managers who are entering this market are required to establish and manage vehicles with which they are less familiar. It is therefore important that managers are able to satisfy themselves that the desired tax and regulatory characteristics of a chosen vehicle will work with the fund's investment strategy, and that adequate resources and procedures are in place to be able to operate this element of the structure.

The Retailisation of Private Equity (continued)

Tax Structuring Challenges (continued)

Managers will also need to consider the level of tax reporting they are prepared to offer retail investors in a particular jurisdiction, including whether the fund sleeve elects into fund tax reporting regimes (e.g. the UK's reporting fund regime for offshore funds). This may result in a material increase in formal tax reporting obligations compared to products without a retail sleeve and therefore managers should satisfy themselves that their tax and accounting functions (including outsourced elements) are able to accommodate these additional requirements.

Retail investors are likely to be sensitive to the attribution of taxable income without cash proceeds (resulting in so-called 'dry tax'). This may become more likely where the sleeve has elected into reporting fund regimes and therefore in such circumstances the manager will need to think about what impact deal structuring has on the possibility of dry tax for certain retail investors. This may put pressure on the use of certain income generating instruments such as profit participating loans or traditional shareholder debt.

Finally, as noted above, a retail sleeve will likely result in the fund carrying out some different activities to comparable funds with solely institutional investors. Specifically, the retail sleeve will draw-down cash from investors up front and may need to comply with redemption requests. This may necessitate that the fund holds a pool of liquid assets to enable it to earn a return on cash awaiting investment and to be able to respond to redemption requests. Careful consideration will need to given to the wider tax impact of this additional investment activity including on any tax planning which is contingent on the fund carrying on traditional medium/long term hold investment activity (e.g. the implications for the German tax status of the fund, access to Income Based Carried Interest relaxations etc.).

In summary, opening up a fund to retail investors will likely add a range of additional tax and structuring considerations, some of which may well be off the beaten track for alternative investment managers. These issues should be manageable but it is important that managers who are looking at this area are prepared for some of the associated tax nuances and factor this into their planning.

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New Luxembourg Securitisation Law - even more flexible and attractive than before

The Luxembourg Securitisation Law of 22 March 2004 has been modernised with the voting in by the Luxembourg Parliament on 9 February 2022 of the "New Law" which will make Luxembourg an even more attractive securitisation jurisdiction.

The two major changes of the New Law relate, firstly with respect to the assets, and secondly with respect to refinancings. There will be more flexibility for both. Actively managed CDO/CLOs can now be more easily established in Luxembourg, and there will be more possibilities in terms of structuring refinancings.

The key modifications are:

- With the New Law, active management (by the vehicle or a third party) is now allowed for Luxembourg securitisation vehicles for risks linked to bonds, loans or other debt instruments, except where financing instruments are issued to the public. This might enable Luxembourg to attract more CDO/CLO structures which have historically been established in other jurisdictions.
- The refinancing of a transaction is no longer limited to securities but any financial instrument, i.e. including promissory notes or loans, as long as the repayable amount depends on the securitised risks. This aligns the New Law with the European Securitisation Regulation which also does not require financing solely in the form of securities. Furthermore, this will reduce legal formalities and costs to establish those securitisations which do not require securities financing.
- The flexibility of compartmentalisation and the choice to create either a securitisation company or a securitisation fund remains an integral part in the New Law.
- The options of legal forms that can be used for a securitisation companies are enlarged by "société en nom collectif" (SNC), "société en commandite simple" (SCS), "société en commandite spéciale" (SCSp) and "société par actions simplifiée", which have been established in Luxembourg law since the adoption of the Securitisation Law in 2004. This will make securitisation even more attractive for investors like private equity houses or family offices who already extensively use partnership structures in Luxembourg.
- The New Law confirms that a securitisation vehicle must be subject to CSSF supervision when it issues to the public on a continuous basis. It enacts the CSSF's interpretation of these two criteria (cf. CSSF FAQ), slightly amending the denomination threshold for public issuances from EUR 125,000 to EUR 100,000. Therefore, only securitisation vehicles issuing more than three times per year non-private placements with a denomination below EUR 100,000 to non-professional investors are required to be authorised by the CSSF now that the New Law is adopted. Failure to comply with CSSF supervision (where applicable) is now subject to sanctions.

New Luxembourg Securitisation Law - even more flexible and attractive than before (continued)

- The treatment and distribution of profits and losses of equity financed compartments is now clearly defined in the New Law stating that this has to be effected on a compartment basis. This clarifies that the shareholders of one compartment can only vote for their compartment and not others (i.e. legal segregation of decision making).
- The New Law also defines the legal subordination of different types of debt and equity instruments issued by a securitisation vehicle. This means practically that if no contractual subordination is used, the securitisation will be outside the scope of the Securitisation Regulation and therefore it will not be necessary to comply with risk retention and other requirements.
- The New Law allows a securitisation vehicle to grant security interests over the assets to parties that are involved in a securitisation transaction but are not direct creditors of the securitisation vehicle (i.e. the granting of securities to third parties involved in the transaction will be allowed).
- The New Law further clarifies that securitisation funds have to be registered with the Luxembourg business register, with existing securitisation funds having to register within six months after entering into force of the New Law.

Next steps

These amendments to the Lux securitisation regime make structuring CLO, CDO and private debt transactions easier and allow for greater flexibility and opportunities to use SVs going forward.

If you would like to hear more about this, or are considering utilising a Lux SV in a debt structure, please do reach out to your usual Lux Reg/Tax team, or Holger von Keutz or Leo Humphries.

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Equity Events – Coming to a Balance Sheet near You!

Over the least few years we have been asked to advise on an explosion of equity events for our alternative investment manager ("AIM") clients, these have ranged from IPO's, reverse SPAC structures, majority M&A deals, GP minority stake deals, the use of specialist finance providers and dealing with Leavers, Retirees and New Joiners.

M&A Deals

The wider market data point reflects our own experience, whilst 2020 was the year for mega deals in the asset management ("AM") world, 2021 saw no let up in M&A activity, research by PwC tracked nearly 300 AM deals in the US market, covering managers, fund services and wealth management. In the AIMS space, M&A activity continues as managers look to buy alternative product specific expertise. Franklin Templeton is reported to be buying Lexington Partners for $1.75bn, T Rowe Price bought Oak Hill Advisors for $4.2bn and Schroders buying a majority stake in Greencoat Capital in December 2021.

IPOs

In the IPO space, 2021 saw Bridgepoint IPO on the London Stock Exchange at a launch value of nearly £3bn. Antin Infrastructure Partners listed in Paris in Sept 2021 raising €500m and recently TPG has announced its intention to list in the US, joining other US listed AIMS, Blackstone, KKR, Carlyle and Apollo.

GP Stake Platforms

GP stake platforms have also been active, historically the market was dominated by AMG, Goldman Sachs Petershill Fund (which itself was listed on the LSE at a $4bn valuation in Sept 2021) and Dyal (a shareholder in Bridgepoint). Recently Bonaccord, which raised a $740m GP stake fund last Summer, last month announced the acquisition of a minority stake in Park Square Capital and that it is looking to raise a second fund of $1.25bn to acquire minority stakes in PE firms. GSAM's Petershill unit recently closed a new $5bn fund focused on GP stakes; last year Blackstone closed their second GP stake fund raising $5.6bn and there are 4 other managers out fundraising looking to raise $14bn of new GP stake funds. Those fund raisings will put a lot of capital in the market looking for GP stake sales.

Equity Events – Coming to a Balance Sheet near You!

Specialised Finance

As the Alts industry has grown in size and complexity an eco-system of specialist finance providers has developed to support the industry covering a range of scenarios, such as, providing NAV based and preferred equity financing at portfolio level, to pre-fund warehouse structure financing, funding LP investor commitments, financing secondary transactions and GP investor buy outs.

An area where we have worked with specialist finance providers recently is in the financing of GP co-investment commitments. As Alts fund get ever larger and we see investors requiring co-investment commitments from the AIM execs of 3.4% or even 5% of AUM raised we have seen clients looking to bring in external finance to fund those co-investment commitments. These transactions can be complex and a fraught with tax risks for the individual participants, for their employer or in relation to complex co-investment, carry and DIMF.

Leaver, Retirements, New Joiners

Across the AIM space there are a number of mature AIM businesses where equity may be concentrated in the hands of a fewer founder owners / partners. Many of those founders are reaching an age when they might want to step back or retire from the business. The solution to the challenge of facilitating an equity exit for someone with highly priced equity might be through a minority equity deal, limited IPO or Specialist Finance provider but it could equally be something which is addressed amongst the Founders and the Next Generation.

Any time there are changes in senior personnel, especially those who hold equity in the AIM, then there can be challenging conversations. This is definitely the case when the AIM is trying to put highly priced equity into the hands of the next generation of senior talent – including situations where teams are lifted out or new individual hires are brought in. The Next Generation might not have the capital to buy the leaving Founder out at the price the leaving Founder wants for their equity stake.

Finding out your legal documents are not fit for purpose at the point of one of these equity events is not ideal, so it is worth revisiting the retirement, good and bad leaver provisions in your AIM legal documents now. Can Leavers retain equity rights? Does that include continued voting rights or profit participation rights? Do the legal documents provide a framework for the reallocation of any equity or carry rights given up by the departing Founder and if so on what basis and using what valuation methodology. It may be that the provisions are not detailed or even not present; and even if Leaver provisions are contained in the AIM documents, do they deliver what everyone expected and do they still work from a tax perspective given the many UK tax changes and HMRC challenges in this area.

Any Equity transaction is challenging and complex, making sure that the structure works from a commercial, practical, legal and tax perspective is absolutely key.

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