

Launching a Listed Closed-ended Fund in the EU



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Introduction

This guide considers some of the key issues a manager should consider in launching a closed-ended fund to be listed on an EU investment exchange. Closed-ended funds do not generally offer redemption to investors nor issue significant new interests after admission, other than via organised placings or new issue “rounds”. They generally have the ability to retain, rather than distribute, capital gains. Typically, such funds are in corporate form and may be established onshore or offshore. Most closed-ended funds which retain their capital gains will look to listing on a liquid EU stock exchange to grant investors liquidity over their interests. The table appended to this note summarises the main requirements of popular fund listing venues in the EU.

UK INVESTMENT TRUSTS AND REAL ESTATE INVESTMENT TRUSTS

In the UK, the Revenue will confer tax exempt status on a number of vehicles including two forms of closed-ended fund: “investment trusts” and “real estate investment trusts” (REITs). In order to obtain classification as either an investment trust or a REIT, listing on one of certain specified stock exchanges is required. Despite the name, these funds will always be in corporate form. Either form of fund will be exempt from tax on capital gains, subject to adherence to various conditions. In addition, a REIT will be exempt from tax on its “property rental income”.

The rules governing UK investment trusts have recently been modernised. With effect from 1 January 2012, the main conditions for approval as an investment trust are: (i) the company’s business must consist of investing its funds in shares, land or other assets with the aim of spreading investment risk; (ii) the company’s ordinary shares must be listed on a “regulated market” (which includes the LSE Main Market) and (iii) the company must not retain more than 15% of its gross income (regardless of source) for any accounting period.

The main conditions for approval as a REIT are: (i) at least 75% of the REIT’s income and of the value of its assets must relate to a property rental business; (ii) the REIT must distribute at least 90% of its net rental income profits for any accounting period; (iii) the tax-exempt property rental business must include at least three properties; and (iv) listing on an exchange recognised for this purpose by the UK Revenue, including the LSE Main Market, the Specialist Fund Market and AIM. The “conversion charge” of 2% of the gross market value of the property portfolio, which previously imposed a significant upfront cost of entry into the REIT regime, has been removed. The UK REIT regime is aimed at property rental companies, not property development companies which carry on a trading, rather than investment, business.

There are restrictions on both REITs and investment trusts being “close companies”. A close company is essentially a company either under the control of five or fewer participators or a company with five or fewer shareholders who are together entitled to the majority of the company’s assets. For REITs, there is an additional tax charge on distributions made to “10% shareholders” (the tax charge intended to reflect the amount of tax withheld in respect of distributions which a 10% shareholder could reclaim under a double tax treaty).

Leveraging secured on the assets of the fund is possible and no limits apply on the amount which can be borrowed. REITs, however, are subject to a tax charge if the profit: financing-cost ratio exceeds 1.25 — the purpose is to prevent a UK-REIT being highly geared, or at least subject to finance costs which reduce the amount of profits available for distribution to shareholders. Finance costs are generally deductible against income.

OFFSHORE JURISDICTIONS FOR THE FUND VEHICLE AND TAX CONSIDERATIONS

As an alternative to obtaining classification as a UK investment trust or REIT, a listed investment fund can be established offshore. In particular, any vehicle which does not wish to obtain investment trust or REIT status will generally be established in an offshore tax exempt jurisdiction.

All offshore vehicles will generate gains free of UK tax, subject to maintaining management and control outside any onshore jurisdiction. Provided any fund incorporated outside the UK is not an “offshore fund” for UK tax purposes, UK individual investors will pay tax on capital at the capital gains rate on the appreciation in the value of their shares in the fund. Generally, a closed-ended fund without a fixed life will not be an “offshore fund” for UK tax purposes.

The position with income is more complex and requires consideration of the underlying assets and the nature of the potential investor base to determine the projected net of tax return which will be earned by relevant classes of investors.

For a UK REIT, property rental income is exempt within the fund, meaning investors are taxed broadly as though they held the property directly. Non-property rental income, which is taxable (after deductible expenses such as management fee) within the fund, is distributed to investors as dividend income with the benefit of the usual dividend tax credit. Accordingly, REITs can produce a higher return from UK sourced rental income than offshore vehicles for UK individuals, non-UK residents and tax exempt investors.

For an offshore fund, income should not be taxed in the local jurisdiction, but (given the non-existence of double tax treaties between offshore and onshore jurisdictions) may be subject to withholding tax at source which could lead potentially to a leakage of dividend, rental or interest income from the fund's portfolio. Distributions from offshore funds will be received by investors gross and so will be subject to tax in the hands of UK investors on receipt.

A further factor to consider is that UK resident individuals who are "non-domiciliaries" for UK tax purposes will benefit from the remittance basis of taxation so are likely to prefer an offshore rather than a UK fund, as such individuals can generally avoid UK tax by not remitting funds into the UK.

The shares of any fund listed on a UK exchange will need to be admissible to CREST, the UK share settlement system, or another electronic system such as Euroclear or Clearstream. Jersey, Guernsey, Isle of Man and Irish shares are eligible for settlement in CREST. Shares issued by entities in other offshore jurisdictions are not eligible for settlement in CREST, although listing of shares by these entities can be achieved by a depositary receipt structure or in the form of CREST depositary receipts.

Transfers of shares in funds incorporated in the UK will generally be subject to a 0.5% stamp duty charge.

CORPORATE AND MANAGEMENT STRUCTURE

Typically, listed investment companies have an entirely non-executive board with the executive and management functions performed by a separate investment manager on the terms of a management agreement. The non-executive board will generally have (and may be required to have) a majority of directors which are independent from the manager.

The investment management agreement will contain the provisions relating to the management fee and performance fee, term and termination — terms which will usually be

debated between the manager and the board, with the assistance of any sponsor or promoter.

In terms of the investment manager's role, it is important to ensure that the activities of the investment manager do not bring the company into another jurisdiction for tax purposes and that VAT leakage is avoided.

It is possible to convert an existing structure (such as a property holding structure) to REIT or investment trust status. A pre-listing re-organisation can introduce a vehicle suitable for listing.

There are a small number of (relatively large) internally managed investment funds.

Investment companies can issue more than one class of shares, allowing a structure where investors can choose between income distributing and income accumulating shares or shares that accrue income or capital at a fixed rate. Note that REITs can only issue non-participating fixed-rate preference shares in addition to issuing ordinary shares.

VENUES FOR LISTING

The most important factor governing the choice of listing venue is liquidity. Liquidity varies widely between the LSE Main Market (in general a liquid market) and AIM, the Specialist Fund Market and Euronext Amsterdam (in general less liquid). Other factors which will govern the choice of listing exchange include the threshold requirements for admission to the exchange, the rules developed by each exchange in relation to portfolio management and disclosure, and the ease of making follow-on offerings.

London offers three potential venues for listing:

London Stock Exchange: Main Market

Shares admitted to the LSE Main Market must be listed by the UK Listing Authority (UKLA). The UKLA distinguishes between a standard listing and premium listing. A standard listing reflects the basic requirements of applicable European Directives for EU recognised stock exchanges. An LSE premium listing imposes requirements which are "super-equivalent" to these requirements, including additional rules on disclosure.

The UKLA requires that investment entities pursue a premium listing. In general issuers selecting a premium listing must demonstrate a track record and operating history. There is, however, a special (mandatory) regime for closed-ended investment entities which does not require them to have a track record. The *quid pro quo* is compliance at and after admission with a number of rules tailored specially to investment entities (which apply to already established investment entities as well as newly formed funds).

The UKLA regards an investment entity as an undertaking whose primary objective is investing and managing its assets with a view to spreading investment risk. Note that any entity which is established as a “cash shell” or “special purpose acquisition company” (SPAC) may not qualify as an investment entity, because of the lack of risk spreading. Any entity which is not an investment entity can choose between a standard and premium listing.

The table appended to this note summarises certain of the admission and ongoing requirements for standard and premium listings.

London Stock Exchange: Specialist Fund Market

The Specialist Fund Market was established in 2007 as a market for closed-ended funds which require the liquidity and status of a London market but not the investor reach or standing of a Main Market listing or listing by the UKLA. It is fair to say that the Specialist Fund Market was originally positioned as a competitor to Euronext Amsterdam. The Specialist Fund Market generally markets itself as a venue for investment entities which are specialised (including single strategy and single asset funds, feeder funds and specialist sector funds) and only target professional or institutional investors. As at June 2012, there were 11 funds listed on the Specialist Fund Market.

Like the LSE Main Market, the Specialist Fund Market is an EU Regulated Market.

AIM

AIM has specific rules for listing funds and other investment entities but is generally only suitable for simple fund structures. The perceived advantages of listing on AIM are, firstly, easier and quicker access to the market (in that a full Prospectus Directive prospectus is not required if the offer is an institutional only offer) and, secondly, no requirement to issue a further admission document for a follow-on offering (again, subject to the offer being an institutional only offer). It is fair to say that the popularity of an AIM listing for funds has declined in recent years.

AIM is not an EU Regulated Market and shares traded on AIM are not officially listed by the UKLA.

In addition, outside London:

Euronext Amsterdam

Euronext Amsterdam has been a popular choice, in part because unlike the LSE Main List, it did not impose requirements over and above those mandated by the relevant EU Directives. We believe that the popularity of listing on Euronext Amsterdam has declined in recent years — in part

due to its reported lack of liquidity and in part due to the modernisation of the LSE’s listing regime for investment entities in 2007.

Euronext Amsterdam is an EU Regulated Market.

SEED ASSETS WITHIN A FUND

If a fund has seed assets in its portfolio at the time of listing, the key questions a manager will ask are, first, to what extent these assets will need to be disclosed to investors at the time of listing, and, second, to what extent will independent valuations be required for such assets. The answer to either question will depend to some extent upon the exchange’s and sponsor or promoter’s views. Real estate assets will inevitably require independent valuations.

Managers may consider listing a fund as a means of realising the underlying portfolio assets for the fund’s existing investors — in other words, as an alternative to sale of the underlying portfolio. The manager will need to consider (at least when the listing venue is the LSE Main Market) whether such a fund should properly be treated as a holding company rather than a fund. The pertinent question is whether the portfolio within the fund will satisfy the UKLA’s risk-spreading requirement.

MARKETING CONSTRAINTS

In general, a fund that is marketed in compliance with the Prospectus Directive rules (which will be the case for an IPO on the LSE Main Market, the Specialist Fund Market and Euronext Amsterdam) can be marketed across Europe using the UK prospectus on the basis of the European prospectus passport. The caveat here is that the fund may be treated as a “collective investment undertaking” in any EU jurisdiction. Collective investment undertakings which are not regulated EU wide UCITS schemes are invariably subject to restrictions on marketing. In the UK, a closed-ended fund in corporate form will generally not be treated as a collective investment undertaking so should fall within the Prospectus Directive regime. (Note that any fund considering making regular market purchases of its own shares will need to consider whether this affects its “closed-ended” status sufficiently to bring it into UK “collective investment scheme” treatment.) Unfortunately, due to uneven implementation of the Prospectus Directive, this is not the case in every EU jurisdiction. France and Italy in particular do not have an exemption for marketing closed-ended companies — until implementation of the EU Alternative Investment Fund Managers Directive, marketing fund-like structures in these countries can be difficult.

IMPLICATIONS OF THE EU ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

The Directive will be implemented into local law by EU states by July 2013 and regulates the managers of all funds in the EU which are not EU regulated UCITS funds. The manager of every EU listed fund is potentially subject to the Directive. The Directive exempts “holding companies” from its scope, which are companies whose subsidiaries carry out a business strategy “to contribute to their long-term value” and which are either admitted to trading on a regulated market in the EU or not established for the “main purpose of generating returns for their investors by means of divestment of the subsidiaries”. The precise scope of the holding company exemption remains to be seen until member states implement the Directive into local law. To the extent the Directive applies, the key implications on listed funds are likely to be as follows:

- The responsibility for overseeing appointment of service providers, for risk and liquidity management and for valuation may lie with the governing body of the listed fund itself. It may be that the fund is required to be authorised under the Directive as if were the manager of the fund. This is a key issue which we shall be monitoring.
- Funds classified as “alternative investment funds” under the Directive can only be marketed to retail investors if member states allow such marketing. The implication here is a potentially severe restriction on the freedom to market funds more widely introduced by the Prospectus Directive. (Note that the marketing provisions of the Directive do not apply to the marketing of shares that are subject to a current offer to the public on an EU regulated stock exchange under a Prospectus Directive prospectus before 22 July 2013).

DISCLOSURE REQUIREMENTS

Public disclosure of a fund’s portfolio will often be a sensitive matter for investors. The UKLA requires a “comprehensive and meaningful analysis” of a fund’s portfolio in its annual report and quarterly management statements. In addition, the UKLA requires disclosure regarding substantial acquisitions. Most other exchanges referred to in this memorandum do not prescribe disclosure obligations, but specific advice as to market practice should be taken before listing.

MANAGING THE DISCOUNT TO NAV

Open-ended funds which offer investors a redemption facility will usually offer redemption at or close to net asset value

(NAV). By contrast, closed-ended funds listed on a liquid exchange face the problem of their shares trading at a price below the underlying net asset value attributable to a share, a result of normal market forces of supply and demand. There are a number of strategies which investment companies and their managers may use to reduce the “discount to NAV”, including repurchasing shares in the market and tender offers. As noted above, listed funds do need to take legal advice in structuring their share repurchase policy, as any such policy may result in the fund becoming for UK purposes an open-ended collective investment scheme, with tax and regulatory implications. However, this strategy can be effective and can be combined with keeping shares in treasury.

CONCLUSION: WHAT ARE THE ADVANTAGES OF FORMING A LISTED CLOSED-ENDED FUND?

The primary advantage of forming a closed-ended fund is that it is a pool of “permanent capital”. Investors have no redemption rights and new issues are at the behest of the directors. The fund can retain capital gains. Closed-ended funds do not face the mismatch that traditional open-ended funds face between the desire to hold assets such as real estate for the long term and the typical investor requirement for 1-monthly or 3-monthly liquidity.

Listing the fund may give investors liquidity — noting that liquidity is by no means assured on every exchange and may in practice only be available to small sized trades.

Investors in closed-ended funds pay income tax when income is distributed to them, so avoid any structure whereby income received by the fund is attributed to investors for tax purposes. Also note that listing a closed-ended fund gives UK investors capital gains tax treatment on disposals and shares within a fund can be included in a UK individual’s “ISA” tax-free wrapper.

CONTACT

For more information on these issues, please contact Andrew Hougie in London or the Dechert attorney with whom you regularly work.

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LISTING A CLOSED-ENDED INVESTMENT ENTITY IN EUROPE – 2012

Admission requirements					
	LSE Main List Premium listing (LR15)	LSE Main List Standard listing (LR14)	AIM	Specialist Fund Market	Euronext Amsterdam
Eligibility	Closed-ended investment funds. ¹	Companies which are not investment entities. ² Cash shells and “SPACs” may be eligible for a Standard Listing.	Investing companies. ³	Closed-ended investment entities targeted only at professional and/or institutional investors.	Typically closed-ended investment entities.
Admission document requirements	Full Prospectus Directive compliant prospectus required under FSA’s Prospectus Rules, plus additional disclosure obligations as set out in the Listing Rules.	Full Prospectus Directive compliant prospectus required, under FSA’s Prospectus Rules.	Admission document must comply with AIM rules, unless an offer to the public is to be made. ⁴	Full Prospectus Directive compliant prospectus required, under FSA’s Prospectus Rules.	Full Prospectus Directive compliant prospectus required.
Review of admission document by regulator	Yes, by applicant’s EEA Competent Authority.		No	Yes, by applicant’s EEA Competent Authority.	Yes, by applicant’s EEA Competent Authority.
Passporting to and from EU	Yes, under Prospectus Directive.		No	Yes, under Prospectus Directive.	Yes, under Prospectus Directive.

1. Defined as an undertaking with limited liability, including a company, limited partnership or limited liability partnership, whose primary objective is investing and managing its assets (including pooled funds contributed by holders of its listed securities) (i) in property of any description and (ii) with a view to spreading investment risk.
2. Defined as an entity whose primary object is investing and managing its assets with a view to spreading or otherwise managing investment risk. Note that an investment entity may apply for a standard listing if it already has a premium listing of a class of its equity shares. Cash shells and special purpose acquisition companies will typically be eligible for a Standard Listing.
3. An “investing company” is defined as a company which has as its primary business or objective the investing of its funds in securities, businesses or assets of any description. The AIM Note for Investing Companies states that the investing company “should usually be a closed-ended entity of a similar structure to a UK plc, not requiring a restricted investor base. It should be straightforward and not complex in terms of its structure, securities and investing policy and should issue primarily ordinary shares (or equivalent).”
4. Note that if the offering is to the public, a Prospectus Directive prospectus approved by the UKLA (or other relevant EEA competent authority) will be required.

Admission requirements (cont'd)					
	LSE Main List Premium listing (LR15)	LSE Main List Standard listing (LR14)	AIM	Specialist Fund Market	Euronext Amsterdam
Sponsor or equivalent required	Sponsor required.	No	Nominated Adviser required.	No	Listing Agent required for admission.
Track record required	No	No	No	No	No
Minimum market cap	£700,000		£3,000,000	None stated.	Euro 5,000,000
Significant restrictions on investment or concentration	Restriction on investment in other listed closed ended funds at admission.	No	No, although an investing company's exposure to risk through any cross-holdings should be considered.	No	No
Prohibition on significant trading activity	Yes ⁵	No	Yes ⁶	SFM is not open to trading companies.	No, although listing agent should be consulted.
Board requirement	The chairman and at least half of the board must be independent from the investment manager. ⁷	No	Board as a whole should be independent from the investment manager.	No	No (other than for locally incorporated entities). Market practice may dictate a majority independent board.
Liquidity	Likely to offer high liquidity.		Likely to offer lower liquidity.		

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5. An applicant must not conduct any trading activity which is significant in the context of its group as a whole. There is no restriction on an applicant taking a controlling stake in an investee company.
 6. The AIM Note for Investing Companies states that the definition of investing company “does not include an AIM company which is a holding company or “topco” for a trading business, but it does include entities such as cash shells, blank cheque companies and special purpose acquisition companies.”
 7. Directors who are not regarded as independent must be subject to annual re-election by shareholders.

Structuring considerations					
	LSE Main List Premium listing (LR15)	LSE Main List Standard listing (LR14)	AIM	Specialist Fund Market	Euronext Amsterdam
Type and jurisdiction of corporate vehicle	<p>Unlisted shares of a company incorporated in a non-EEA State are eligible for listing.⁸</p> <p>Currently, vehicles of choice are UK public companies and Guernsey or Jersey companies.</p> <p>Eligibility for settlement in CREST needs to be considered. UK, Irish, Isle of Man and Guernsey shares are eligible for settlement in CREST.</p>		<p>UK and non-UK domiciled entities are eligible.⁹</p> <p>Eligibility for settlement in CREST needs to be considered. UK, Irish, Isle of Man and Guernsey shares are eligible for settlement in CREST.</p>	<p>UK and non-UK domiciled entities are eligible.</p> <p>Eligibility for settlement in CREST needs to be considered.</p>	<p>No restrictions, other than that securities must be freely transferable and tradeable. Fast track listing option is available for vehicles in Guernsey, Ireland, Jersey, Luxembourg, Malta or US.</p>
Local regulatory considerations	If a closed-ended body corporate, should not be classified as a UK collective investment scheme.				Subject to local regulatory considerations.
Feeder funds	Yes ¹⁰	Not applicable.	Yes	No restriction on listing feeder funds.	Yes
Partly paid structure	Yes, if transferability is not restricted and investors have been provided with appropriate information.		No restriction stated.	No restriction stated.	Yes
Depository receipts	Yes. For an investment entity, depository receipts may only be listed if the underlying securities are already (or simultaneously) listed.		Yes		
Non-voting shares	Yes		No restriction stated.	No restriction stated.	Yes

8. The FSA will not admit shares of a company incorporated in a non-EEA State that are not listed either in its country of incorporation or in the country in which a majority of its shares are held, unless the FSA is satisfied that the absence of the listing is not due to the need to protect investors.

9. Rules state that the issuer should usually be “closed-ended of a similar structure to a UK plc”.

10. Feeder funds must ensure that the master fund’s investment policies are consistent with the applicant’s investment policy.

Continuing obligations					
	LSE Main List Premium listing (LR15)	LSE Main List Standard listing (LR14)	AIM	Specialist Fund Market	Euronext Amsterdam
Follow-on offerings	Unless authorised by shareholders, pre-emptive offer round must be made if shares of same class are being offered at less than NAV. Prospectus required to offer new shares unless the shares represent less than 10% of number of shares in the same class already admitted to trading.	Prospectus required to offer new shares unless the shares represent less than 10% of number of shares in the same class already admitted to trading.	Further admission document is not required if the issuer is (i) not required to issue a prospectus under the Prospectus Rules or (ii) not seeking admission for a new class of securities.	Prospectus required to offer new shares unless the shares represent less than 10% of number of shares in the same class already admitted to trading.	Prospectus required to offer new shares unless the shares represent less than 10% of number of shares in the same class already admitted to trading.
Free float requirement	25% of each class.	25%	None. Exchange relies on nominated adviser assessment of suitability.	None stated.	Generally, 25%, but may allow lower percentage if market can function at lower level.
Ongoing reporting	Annual and semi-annual financial reports. A closed-ended investment fund must include in its financial report “a statement as to whether in the opinion of the directors the continuing appointment of the investment manager is in the interests of the shareholders, with reasons for this view”. Note requirement for annual portfolio valuation for companies which invest more than 20% of assets in property.	Annual and semi-annual financial reports.	Annual and semi-annual financial reports.	Annual and semi-annual financial reports.	Annual and semi-annual financial reports

Continuing obligations (cont'd)					
	LSE Main List Premium listing (LR15)	LSE Main List Standard listing (LR14)	AIM	Specialist Fund Market	Euronext Amsterdam
Other shareholder approval requirements	A closed-ended investment fund must obtain the prior approval of its shareholders to any material change to its published investment policy.		An investing company must seek shareholder consent for any material change to its investing policy.	None	None (other than for locally incorporated entities).
Disclosure or shareholder approval requirements for transactions	Transactions within investment policy are not subject to shareholder consent. Related party transactions subject to notification. ¹¹	No	Disclosure not required to the extent transaction is in accordance with investing policy and only breaches the profits and turnover tests. Disposal in accordance with investing policy is not subject to requirement for shareholder consent.	No	No (other than for locally incorporated entities).

11. An investment manager is treated as a related party. So transactions between the issuer and other funds managed by the investment manager are potentially subject to shareholder notification.

Continuing obligations (cont'd)					
	LSE Main List Premium listing (LR15)	LSE Main List Standard listing (LR14)	AIM	Specialist Fund Market	Euronext Amsterdam
Disclosure requirements for portfolio	<p>Disclosure of holdings in other listed closed-ended investment funds and compliance with disclosure rules relating to inside information.</p> <p>In the annual report, “comprehensive and meaningful analysis of its portfolio” is required. Additional requirements for property investment entities.</p>	None, other than compliance with disclosure rules relating to price sensitive information.	None, other than general disclosure obligation relating to new developments concerning change in financial condition, sphere of activity etc.	None, other than compliance with disclosure rules relating to price sensitive information.	None, other than compliance with disclosure rules relating to price sensitive information.
Regulated Market¹²	Yes		No	Yes	Yes

12. Admission to trading on an EEA Regulated Market triggers the application of the EU Prospectus Directive, Transparency Directive and Market Abuse Directive.

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This guide is intended to provide general information; it is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

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