167 Fleet Street, London EC4A 2EA, UK
+44 (0)20 7822 8380
info@aima.org

aima.org

David Butler
Financial Services Taxation
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

By email: david.butler@hmtreasury.gov.uk

30 July 2019

Dear David,

RE: Reform of UK Securitisation Company Regulations

We have discussed within the Alternative Investment Management Association ("**AIMA**")[1] and the Alternative Credit Council ("**ACC**")[2] your query concerning any potential impact the changes we are proposing to the provisions of the Taxation of Securitisation Companies Regulations 2006 (S.I. 2006/3296) (the "**Regulations**") may have on the wider UK regulatory approach to securitisations.

Our proposals are aimed at facilitating the more efficient use of securitisation companies qualifying under the Regulations by the new range of UK domiciled professional investor fund structures we are proposing for the post Brexit environment.

The proposed changes we are seeking to the Regulations are set out and more fully explained in the **Annex** to this letter. These changes are primarily to the definition of a "*note-issuing company*" under the Regulations and can be summarised as follows:

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,700 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $1.5 trillion in assets.

[2] The ACC is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 80 members that manage US$300bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SME's, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. See more at: https://www.aima.org/acc/about-the-acc.html#sthash.mx18CD49.dpuf/.

1. The amendment of the requirements as to what is a qualifying *capital market investment* and *capital market arrangement* for the purposes of Condition A of the definition in Regulation 5(2) in order to more closely reflect the operational requirements of professional investor funds which may wish to utilise a securitisation company structure and the fact that there should be no absolute requirement for a security trustee arrangement;

2. The amendment of the independent person requirement under Condition B of the definition in Regulation 5(3) to permit the shares in a securitisation company to be held by the fund holding the *capital market investment* or by the investment manager to that fund or another company in its group or by the general partner of a fund in partnership form;

3. The amendment of the £10 million issue threshold under Condition C of the definition in Regulation 5(4), either by removing this condition entirely or by amending it to (i) reduce this threshold to a lower monetary amount and (ii) provide for a "ramp up" period to reach the threshold which would apply provided there is an intention to reach it; and

4. The amendment of the definition of "*financial asset*" in Regulation 9A as it applies under Condition D of the definition in Regulation 5(5) to permit a securitisation company to invest in shares and related derivatives. We would also suggest that Regulation 5(5)(a)(i) be amended for clarification to include a reference to "selling" and the activity of advancing credit. In all cases, the activity could not, of course, give rise to trading.

We would also recommend consideration be given to amending Section 755 of the Companies Act 2006 to add a specific exemption permitting UK securitisation companies issuing capital market investments to investors as part of a professional investor fund structure not to re-register as public limited companies, as more fully explained below.

We also believe there is an opportunity to improve existing HMRC Guidance as it applies to securitisation companies under the Regulations in order to facilitate use of these structures by the financial services industry in the UK.

Finally, as also more fully explained in the Annex, it is our view that the proposed changes should not affect whether or not a UK securitisation company structure falls within the definition of "*securitisation*" under the EU Securitisation Regulation (No. 2017/2042) or a UK securitisation company falls within the definition of "*securitisation special purpose entity*" used in the relevant exemptions under the EU Alternative Investment Managers Directive (no.2011/61/EU) ("**AIFMD**").

We have discussed separately with HM Treasury and HMRC the application of the VAT Directive exemption for management of "special investment funds" to UK domiciled professional investor funds. It would be important for the VAT exemption to be applied by the UK to the management of securitisation companies (as is the case in certain other member states).

We trust you find these comments useful. We would welcome the opportunity to discuss them with you and to answer any questions you may have.

Yours sincerely

Paul Hale
Managing Director, Global Head of Tax Affairs
AIMA

Annex

1. Analysis of Current UK Securitisation Company Regulations

Funds based in jurisdictions outside the UK often use securitisation companies for the purposes of tax efficiency in circumstances where the fund itself is not subject to tax (and therefore unable to access double tax treaty benefits) and uses a securitisation company as a taxable, treaty eligible vehicle through which it invests in order to achieve tax neutrality for the fund's investors.

In Europe, securitisation companies are typically established either as Irish companies complying with section 110 of the Irish Taxes Consolidation Act, 1997 ("**Section 110 Companies**") or Luxembourg securitisation structures. As fund domiciles directed predominantly at UK and international managers, both Ireland and Luxembourg have encouraged their securitisation company regulations to develop over time to meet the needs of management groups using their fund structures, including by permitting their securitisation companies to be structured as relatively small private companies and to invest in a wide range of asset classes. By contrast, the current UK securitisation company regulations are more narrowly constrained – apparently intended mainly for use by larger issues of listed debt securities – and would generally be inadequate for use in post Brexit UK domiciled professional investor fund structures.

Securitisation Company definition
The principal constraints lie within the definition of "*securitisation company*" in the Regulations.

Specifically, Regulation 4 requires that a "*securitisation company*" meet two conditions: that it is a company meeting one of five specified types – here, the "note-issuing company" type would appear to be the most relevant to private fund structures – and that it have a "retained profit".

Note-issuing Company definition
In turn, the "*note-issuing company*" definition in Regulation 5 imposes four conditions (A through D), which attract most of our suggestions for change, as follows:

Condition A requires that the note-issuing company satisfies the requirements for a "*securitisation company"* under section 623 of the Corporation Tax Act 2010 (the "**CTA**"). This in turn requires that the company is a debtor to a "*capital market investment*" and the capital market investment is part of a "*capital market arrangement*", each as defined under section 72B of and Schedule 2A to the Insolvency Act 1986 (the "**IA**").

A "*capital markets investment*" in this context must be a debenture or alternative debenture (as defined in article 77 or 77A of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "**RAO**")) that is one of the following:

1. rated by an internationally recognised rating agency;
2. listed on the UK's Official List;
3. admitted to trading on a UK *recognised investment exchange* or on a *foreign market*; or
4. issued to one or more persons falling within certain of the exempt categories under the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "**FPO**"), including *investment professionals* within FPO Art. 19(5) and the *"high net worth" companies, partnerships and trusts* within FPO Art 49(2), both as modified in CTA Sched. 2A, para.3. (See CTA Sched. 2A, paras.2 and 3.)

There are a number of adjustments which would need to be made to these requirements to facilitate the use of note-issuing company structures by professional investor funds.

Point (4) above should be sufficient for most professional investor fund structures in that it would permit investment in the debentures by a corporate fund with net assets of at least £5 million (falling to £500,000 if the fund has more than 20 shareholders), a partnership fund with assets of at least £5 million or a unit trust with gross assets of at least £10 million. However, it would be helpful to clarify this requirement to make it clear that an investment fund (whether in corporate, partnership or unit trust form) which is in the initial phase of its life is treated as satisfying the requirement either on the basis of its drawn and undrawn commitments or its intention to seek to raise funds sufficient to meet this requirement.

The definition of "*capital market arrangement*" requires that the issue of the relevant *capital market investments* also involves certain kinds of grants of security or performance guarantees to third party trustees or nominees for the benefit of investors. Whilst it might be possible to make this work for larger professional investor fund structures which are prepared to incur the not insubstantial cost of employing a full blown security trustee to take the grant of security over the assets of the securitisation company for the benefit of the investor fund, this would impose a substantially higher burden on managers than, for example, Irish section 110 arrangements which in a fund context very often do not involve the grant of security over the securitisation company's assets or the use of a security trustee. Accordingly, we would propose that professional investor fund structures should not be required to implement such security or security trustee arrangements if this is not in their view a requirement of their investment.

A fund investing in listed equities or derivatives might qualify by use of a total return swap on the basis that the arrangement involves a contract for differences (see CTA Sched. 2A, para.1(1)(d)).

Finally, in relation to the definition of *capital market investment*, it would also be helpful to remove the requirement that bond structures under Article 77A be listed or traded and to clarify that wider forms of loan based financing are permitted where required in terms of the operational efficiency of the arrangements.

Condition B requires that the securities that represent the *capital market investment* are issued wholly or mainly to independent persons. For these purposes, "*independent persons*" is defined to mean, in very broad terms, persons that do not have control of the company or who are not under control of the same person as the person who controls the company, including control by the direct or indirect ability to acquire the greater part of the shares, capital or voting rights of a person (see Regulation 2(1) and (3) and CTA sections 1122, 1123, 450 and 451).

Accordingly, Condition B would require that the debentures be issued wholly or mainly to persons who are not in the same corporate group as the securitisation company or which otherwise do not control the voting rights in the securitisation company.

In the context of a professional investor fund investing in the debentures, this would mean that the shares in the securitisation company could not be held by the fund or by anyone in the same group as its investment manager. Whilst it might be possible to have the shares in the securitisation company held by a truly independent third party on trust – e.g. for a charity – it would be preferable if this requirement were relaxed to permit the shares to be held by the fund, or the investment manager or

another company in its group or the general partner of a fund in partnership form.

Condition C is that the value of the debentures issued under the capital markets arrangement is at least £10 million. This relatively high threshold could be problematic for many professional investor funds, particularly (a) where the fund uses the securitisation company to acquire a portfolio of investments and will initially be below the threshold and (b) the fund employs a number of securitisation company structures – e.g. across different asset classes, currencies and/or markets – where some of the individual securitisation companies may be relatively small. We would therefore suggest either removing this condition entirely or amending it to (i) reduce this threshold to a lower monetary amount and (ii) provide for a "ramp up" period to reach the threshold which would apply provided there is an intention to reach it.

Condition D imposes a requirement that the note issuing company's only business other than issuing notes and incidental activities consists of, broadly, "acquiring, holding and managing" financial assets forming all or part of the security for the debentures. Unfortunately however, "financial asset" is defined very narrowly in Regulation 9A specifically to exclude shares, derivative contracts on shares and loans which embed such derivatives. This restriction renders securitisation companies useless for professional investor funds investing in equities, including private equity funds and real estate and other tangible asset funds that invest via shares in holding companies. Irish Section 110 Companies do not have this restriction and are specifically permitted to hold shares and related derivatives. We would therefore suggest amending this Condition to permit investment in shares and related derivatives. We would also suggest that Regulation 5(5)(a)(i) includes an express reference to "selling" financial assets for clarity. We would also propose that the "*acquiring, holding and managing*" financial assets rule is widened to include the activity of "*advancing*" credit. Currently, whilst it is possible to reach the view that advancing credit is not evidence of trading and is more akin to investment activities associated with the acquiring, holding and management of credit, it would be helpful if the legislation made this explicit on this point. In all cases, the activity could not, of course, arise to trading. We note below some uncertainty regarding the definition of *"incidental activities*" and how this could be clarified in the guidance.

Retained Profit

Finally, a securitisation company is required to have a "retained profit", which is defined in Regulation 10 to include, in general terms, such amounts as are required to be retained under the terms of the debentures. While, broadly, this requirement should not be problematic, this would be an opportunity to consider whether it would be appropriate to adopt an approach more in line with that of the Irish and Luxembourg regimes which would avoid the need for an annual distribution on the notes and reinvestment and issuance of further tranches. It may be that this is in part an issue of how profits are recognised under the relevant GAAP.

2. Impact on the Application of EU Securitisation Definitions

The disparate EU regulation of securitisations, including under the EU Capital Requirements Directive (No. 2013/36/EU) / Capital Requirements Regulation (No. 575/2013) and AIFMD, has now largely been concentrated and expanded in the EU Securitisation Regulation (No. 2017/2042).

As regards AIFMD in particular, the prohibition in Article 17 on EU AIFMs investing in non-compliant securitisations has now been overtaken by the Securitisation Regulation. However, the general exemption in Article 2(3)(g) for "securitisation special purpose entities" retains the original definition that incorporates a 2008 ECB regulation on securitisations (Regulation (EC) No. 24/2009; ECB/2008/30).

2.1 The Securitisation Regulation

The Securitisation Regulation defines a "securitisation" as:

> "a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:

a) payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;
b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;
c) the transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013." (Article 2(1))

In turn, the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013 are as follows:

a) "the exposure is to an entity which was created specifically to finance or operate physical assets or is an economically comparable exposure;
b) the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate;
c) the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise."

It will be obvious from the foregoing that the tests used in this definition are entirely different to those used in the "securitisation company" definition in the Regulations, so that not all UK securitisation company structures (i.e. transactions and schemes, using the terminology of the Securitisation Regulation) will qualify as securitisations under the Securitisation Regulation. This is unsurprising as the UK securitisation company definition dates from 2006 whereas the EU regulation of securitisations, which the Securitisation Regulation largely replaced, dates from 2009.

Consequently, none of the technical changes to the UK "securitisation company" definition suggested above should impact such a UK securitisation company's compliance (or not) with the Securitisation Regulation's definition of "securitisation".

2.2 The AIFMD Securitisation Special Purpose Entity Exemption

AIFMD provides at Article 2(3)(g) a general exclusion for "securitisation special purpose entities", defined as follows:

> "entities whose sole purpose is to carry on a securitisation or securitisations within the meaning of Article 1(2) of Regulation (EC) No 24/2009 of the European Central Bank of 19 December 2008 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions and other activities which are appropriate to accomplish that purpose" (AIFMD Art. 4(1)(an)).

In turn, Article 1(2) of Regulation (EC) No 24/2009 of the European Central Bank of 19 December 2008 provides:

> "'securitisation' means a transaction or scheme whereby an asset or pool of assets is transferred

to an entity that is separate from the originator and is created for or serves the purpose of the securitisation and/or the credit risk of an asset or pool of assets, or part thereof, is transferred to the investors in the securities, securitisation fund units, other debt instruments and/or financial derivatives issued by an entity that is separate from the originator and is created for or serves the purpose of the securitisation, and:

a) in case of transfer of credit risk, the transfer is achieved by:
   – the economic transfer of the assets being securitised to an entity separate from the originator created for or serving the purpose of the securitisation. This is accomplished by the transfer of ownership of the securitised assets from the originator or through sub-participation, or
   – the use of credit derivatives, guarantees or any similar mechanism;

and

b) where such securities, securitisation fund units, debt instruments and/or financial derivatives are issued, they do not represent the originator's payment obligations".

For the avoidance of doubt and as indicated above, this definition used in AIFMD was not amended or replaced by the Securitisation Regulation.

As with the Securitisation Regulation definition, this definition is entirely different from the "securitisation company" definition in the Regulations, and none of the technical changes the UK "securitisation company" definition suggested above should impact such a UK securitisation company's compliance (or not) with it.

3. Additional Observations

3.1 AIFMD application – Whether UK securitisation companies qualify as AIFs

As will be apparent from the foregoing, but for the avoidance of any doubt, the current UK securitisation company regulations can produce structures that either amount to AIFs, or do not amount to AIFs, depending amongst other things on whether the securitisation company qualifies under the general exclusion for "securitisation special purpose entities" in AIFMD Article 2(3)(g).

This is unsurprising given that the UK securitisation company definition dates from 2006 and therefore predates both AIFMD itself, which dates from 2011, and the EU regulation of securitisations on which AIFMD's "securitisation special purpose entity" exclusion relies, dates from 2009.
The technical changes requested in this letter should not alter this position.

3.2 Companies Act Considerations – Offer of debentures to the public

Section 755 of the Companies Act 2006 prohibits a private company limited by shares or limited by guarantee and having a share capital from making an offer to the public of any of its debt securities (debentures). In many circumstances, this would require a UK securitisation company issuing its debt securities to external investors as part of a professional investor fund structure to become registered as a public limited company ("**PLC**"). However, this would limit the attractiveness of the structure to US tax exempt investors because, unlike a private limited company, prevailing US tax legislation does not permit a PLC to "check the box" in order to be treated as tax transparent for US tax purposes. The legislation applicable to Irish Section 110 Companies makes specific provision to avoid this problem

arising by making available to Section 110 Companies a specific exemption from the Irish requirement to register as PLCs.

Two potential options for avoiding having such a UK securitisation company re-register as a PLC in order to comply with Section 755, could be to incorporate the securitisation company either as an unlimited company or as a company limited by guarantee and not having a share capital. However, both options would be unattractive in the context of a professional investor fund structure in that they would increase the risk of unexpected cross-structure liability.

We would therefore recommend adding a specific new exemption to Section 755 of the Companies Act 2006 permitting a UK securitisation company issuing debentures to investors as part of a professional investor fund structure not to re-register as a PLCs.

For the avoidance of doubt, it might be argued that Section 755 as currently drafted may not prohibit a UK securitisation company from being used as a special purpose vehicle within certain professional investor fund structures, provided its issue of debentures in that context could be regarded as not amounting to an "offer to the public" under one of the bases listed in Section 756(3) of the Companies Act. Nevertheless, the new exemption requested above would still be beneficial here as it would offer greater certainty to this position.

4. Updating HMRC Guidance

In the short term, we believe that amendments can be made to HMRC guidance to ensure that it properly illustrates the range of circumstances that can qualify, and to ensure that points of uncertainty do not unnecessarily undermine the positive aspects of the regime. We would like to point out that these suggestions should not be at the expense of moving ahead with more fundamental reform.

4.1 Further examples

We recommend that more examples are placed into the guidance to showcase the full range of funds that can qualify into the securitisation company regime. For example, we would like to see an example of a UK vehicle below a direct lending fund.

4.2 Incidental activities

HMRC's guidance in CFM72380 states that "the company's only business, apart from being a debtor to a capital market arrangement and apart from any incidental activities, must be either acquiring, holding and managing financial assets or acting as guarantor in respect of loan relationships, derivative contracts, finance leases, or other liabilities of other companies".

We believe clarification should be provided on what HMRC deems to be "incidental activities". Activities such as hedging or put options might not naturally fall within the definition of "acquiring, holding and managing financial assets": therefore, it would be helpful if typical "incidental activities" such as these could be highlighted to reduce uncertainty.

4.3 Modification to other tax rules

In the HMRC guidance manuals, we recommend that page CFM72630 is updated to ensure recent corporation tax rules are also "switched off" in relation to companies that are taxed under the

regulations. This would include:

- Transfer pricing adjustments
- Restriction on relief for interest deductions
- Hybrid mismatch rules
- Diverted profits tax

Although it may be assumed that these rules are effectively switched off by virtue of the way the regime operates, because it has not expressly been stated, there is often uncertainty and therefore apprehension about using the regime. A simple update to the guidance would reverse this anxiety.

4.4 The payments condition

A securitisation company is not entitled to the benefits of the regime if it fails to satisfy the "payments condition" at any time as set out in Regulation 11. We understand the purpose of this requirement is to ensure that the securitisation vehicle does become a cash box. In some respects satisfying this condition is straightforward, as the documentation (priorities of payments and cash management schedule) can be evidenced, however there is some uncertainty on the extent of tracing cash in and out that is necessary such that this condition can feel more onerous than it is. We therefore suggest that the guidance is updated to reflect the point that whilst overall payments in and out are equal, there will be instances, where for example an individual cash stream like capitalised interest would not be expected to pay out.