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EU Financial Services Group Briefing

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HEDGE FUNDS: FSA DISCUSSION PAPER AND THE SHORT SELLING DEBATE

The UK Financial Services Authority (FSA) has recently published Discussion Paper 16 entitled "Hedge funds and the FSA" (the "DP"). As with all other FSA publications, the DP can be found in the publications section of the FSA website, www.fsa.gov.uk.

The DP discusses both the current regulatory approach to the marketing of hedge funds in the UK and the regulation of hedge fund managers, over 100 of whom operate and are regulated by the FSA in the UK, and floats some potential changes.

For the purposes of the DP, FSA tacitly works from the definition of a hedge fund as "any pooled investment vehicle that is privately organised, administered by professional investment managers, and not widely available to the public."

In addition, FSA is under pressure from some quarters in the UK to introduce disclosure in relation to short selling stock. Pronouncements from its Chairman, however, indicate a disinclination to follow this approach and the DP confirms that. Nevertheless, FSA will issue a further discussion paper on this topic in November.

I. Purpose and Suggestions

The two main subjects covered in the DP are:

- Selling and marketing of hedge funds in the UK; and

- The regulation of UK based hedge fund managers.

These are both items of direct concern to the FSA which, correctly, points out that it does not have the power to regulate the funds themselves. Nevertheless the FSA does, in addition, come out with some interesting ideas, essentially around whether the current restrictions on the sale and marketing of hedge funds in the UK could be relaxed either by the creation of a new category of UK authorised hedge fund or by extending the listing rules to cover certain types of hedge fund.

II. The Hedge Fund Market and How It Is Changing

FSA draws attention to the significant growth of the hedge fund industry since 1990, estimating current total assets under management in the hedge fund industry being between US\$450 billion and US\$500 billion. The number of hedge funds managed in Europe rose from 317 to 446 in the year 2001. New entrants fall into three categories: "boutiques" with between \$5 million and \$50 million in capital under management; in-house funds set up by existing asset managers, banks and securities firms; and larger, independent hedge fund groups.

As for investors, they have tended to be high net worth individuals (HNWI's) and private endowment funds, with increasing interest being shown by pension funds and insurance companies.

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III. FSA's Regulatory Approach to Hedge Funds and Their Managers

Marketing of hedge fund products in the UK

FSA correctly notes the standard structure of a hedge fund as being an offshore open-ended investment company (or sometimes a limited partnership) managed, for the purposes of this debate, by UK fund managers. FSA comes into contact with the hedge fund business through its directly regulated UK managers and through intermediaries who advise on investment into funds. As noted above, however, the funds themselves, being located in offshore jurisdictions such as the Cayman Islands, are outside the scope of FSA's jurisdiction.

Currently in the UK hedge funds so structured are classified as "unregulated collective investment schemes" and can only be marketed by authorised persons to market counterparties, intermediate customers and private customers who have opted up to treatment as intermediate customers.

In spite of the marketing restriction for unregulated collective investment schemes, sometimes a hedge fund might take the form of a closed-end listed investment company which enables it to fall under different legislation to reach a broader spread of investors in the UK, for example through funds of hedge funds.

The regulation of hedge fund managers based in the UK

UK regulated hedge fund managers are subject to appropriate FSA rules. Although they are at the bottom of FSA's radar when it comes to risk assessment, they must nevertheless ensure that they have adequate systems and controls in place.

Market confidence issues

FSA has as one of its statutory objectives the maintenance of market confidence. Following the LTCM debacle a number of initiatives led to a lengthening of international regulation such that counterparty risk monitoring in the financial sector, and in particular of highly leveraged institutions (HLI's), has been significantly strengthened. In any case FSA does note that the majority of hedge funds are of insufficient size to cause any threat to the financial system as few of them are HLI's.

Hedge funds and FSA's financial crime objective

FSA is obliged to reduce financial crime and hedge fund managers, as with all other financial institutions in the UK, are subject to appropriate money laundering laws. FSA itself has the power to prosecute breaches of those laws.

IV. Proposals and Points for Discussion

General principles

In outline FSA is satisfied with the current regime but it does wish to explore some alternatives.

As a starting point it notes that any changes to the regulatory environment may incur additional costs to FSA which, being funded by fees paid by the industry, would be reimbursed by increased charges on the regulated community.

Marketing of hedge funds

FSA can see some potential benefits from liberalising the regime to permit hedge funds to be sold to retail investors, in that it would increase product choice for consumers. In an annex to the DP FSA has posed some specific questions relating to the issues raised in it. We have appended these to this briefing. Questions 1 to 3 concern the assessment of demand to sell hedge fund products to the retail sector.

FSA has identified two potential steps it could take within the powers currently granted to it, namely:

- to bring certain types of hedge fund within the scope of funds that it may authorise; or
- to revise the listing rules to allow individual funds to list in the UK.

Question 4 addresses these issues.

Authorising hedge funds

FSA recognises that, given the spread of investment styles and policies followed by hedge funds, it would not be possible to create a UK domestic authorised hedge fund product which covered all of those. Currently it can only authorise unit trusts and investment companies

with variable capital. The specific rules that currently apply to them include a limit of 10% on borrowing, spreading of risk and prospectus requirements. FSA does nevertheless envisage that certain hedge fund strategies could be incorporated as categories of onshore fund within its Collective Investment Schemes (CIS) Sourcebook, for example long/short equity or fixed income arbitrage strategies.

Given that FSA is to undertake a fundamental review of its CIS Sourcebook in the first quarter of 2003 this is now an opportune moment to consider the changes and those who would be interested in pursuing that line of enquiry are encouraged to. Questions 5 to 7 address this issue.

Listing rules

It is difficult for hedge funds to meet the criteria for listing in the UK (other than funds of hedge funds as they invest on a conventional long only basis). The general requirement of listed funds in the UK is that there is risk spreading within the portfolio and hedge funds as a whole are not considered to meet this requirement.

In one of its guises FSA is the listing authority for the UK. If it were to allow hedge funds to list it might need to introduce into the listing rules additional safeguards dealing with the specific characteristics of hedge funds, particularly the forms of disclosure that might be required. The definition of an adequate spread of risk in relation to hedge funds would need to be tackled, in particular concerning shorting of investments. That might involve setting a maximum percentage of the fund that could be put at risk from any one short position, similar to the current 20% concentration limit on long positions.

Another possibility would be to set a minimum share denomination at issuance, e.g. £100,000, to provide an intermediate form of quasi sophisticated investor threshold. Questions 8 and 9 in the Appendix address this consideration.

Regime for hedge fund managers

Some hedge fund managers report to FSA that the label of FSA regulation attracts business to them, and others say that it does not make any difference. However, hedge fund investors should not mistakenly infer regulatory oversight from FSA regulation. Question 10 of the Appendix addresses this issue.

Hedge fund trading issues: short selling

Concerns have been raised about the effects on markets of short selling by hedge funds and others. FSA would need to do a cost benefit analysis if it were to introduce regulatory provisions to deal with concerns about short selling. Its current position is that short selling can provide the market with two important benefits; market liquidity and pricing efficiency, and therefore FSA sees no case for any outright ban on short selling which it judges unnecessary. If there were to be a reporting regime in relation to short selling then that too would impose increased regulatory obligations on managers and increase the cost of regulation. Question 11 in the Appendix addresses this point.

In fact, as noted above, FSA is to publish another Discussion Paper later in the year on the short selling issue and we will report on that in a future briefing.

Financial crime

FSA does not believe that there is sufficient hard evidence to support the view of some that hedge funds, with their opaque structures, international character and lack of direct regulation, are conduits for the proceeds of crime. Question 12 addresses this point.

V. Responses

The deadline for responses to the paper is 29 November 2002. After that, FSA will consider whether to change its rules or supervisory regime and will publish a feedback statement. Responses received will be factored into related FSA reviews of the regimes for listing and collective investment schemes mentioned above.

VI. AIMA Working Group

The London based Alternative Investment Management Association (AIMA) (www.aima.org) has established a working group to co-ordinate the responses of its membership to the DP and will produce a formal response to FSA. We are represented on the working group and will be happy to factor in clients' concerns on an appropriate basis.

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APPENDIX
Questions Posed By FSA

Q1: Do respondents agree that there is no strong case for reforming the regime for the marketing and selling of hedge funds to sophisticated investors?

Q2: Do respondents believe that hedge funds, or certain types of hedge funds, can be suitable products to be marketed and sold to the retail sector?

Q3: Is there significant demand from firms to sell hedge fund products to the retail sector? Would there be significant demand for hedge fund products from retail consumers if FSA liberalised rules to allow them to be sold to the retail sector?

Q4: Are there any other options not considered in this paper that respondents think FSA should consider in relation to the marketing and selling of hedge funds in the UK?

Q5: Do you think that hedge funds would wish to comply with the current regulatory regime for authorised collective investment schemes if the categories of authorised funds were extended to cover certain types of hedge fund strategy? If not, what aspects of that regime would need to be changed and in what manner to suit particular types of hedge funds?

Q6: Which types of hedge fund strategy do respondents think we should consider in our forthcoming fundamental review of the Collective Investment Schemes Sourcebook?

Q7: If FSA were to authorise certain hedge fund strategies as described above, what strategies should FSA and/or the industry adopt to provide retail consumers with appropriate information about the risk profile of hedge funds?

Q8: Would there be significant demand for shares in hedge funds if FSA introduced new Listing Rules to allow them to list?

Q9: What safeguards would FSA need to build into its listing rules, both in terms of eligibility for listing and additional disclosure requirements, if FSA were to consider such a change? Should FSA consider setting a high minimum share denomination at issuance?

Q10: Do you consider FSA's regulatory approach towards UK hedge fund managers to be appropriate? Are there any changes it should consider making, within the constraints set down under the Act?

Q11: Is FSA's approach to monitoring the overall hedge fund market appropriate? Are there additional actions FSA should consider taking with respect to hedge funds that would improve confidence in the UK's financial markets?

Q12: Is FSA's approach to implementing FSA's financial crime objective appropriate for hedge fund managers? Is there multilateral action to which FSA should contribute through international fora?

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