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FSA Proposes Non-Retail Authorised Funds - Will Hedge Funds Come Onshore?

CP 185

Last month FSA issued its consultation paper (CP 185) on its new approach to fund regulation. The CP proposes to overhaul the regulations for FSA authorised funds in the UK. The FSA says, and it is difficult to disagree, that the current rules are too prescriptive, based as they are on the old pre-FSA and Financial Services and Markets Act 2000 regime. FSA has blown off the dust and its new ideas, if not revolutionary, are a welcome breath of fresh air and doff the cap at innovation. Given the significance of the changes in CP 185 as a whole, the consultation runs to 31 October.

In outline, and mindful of the need to innovate when the circumstances are right, and assuming the proposals in the CP are adopted in substantially this form, the current Collective Investment Schemes (CIS) Sourcebook will be scrapped and replaced by a slimline, more flexible version. The new sourcebook avoids the over prescriptive style of its predecessor and shifts towards a more disclosure orientated regime putting the onus on fund managers to reveal the salient features of a fund in the prospectus, rather than disclosing on a regulation box ticking approach.

So why should the CP be of interest to the alternative investment management industry? It provides for the first time for an authorised non-retail fund (the "New Fund"). This is a belated, but nevertheless welcome, acknowledgement by FSA of the desirability of a quasi-retail authorised fund product which can meet the needs of the institutional and expert private investor, using investment styles currently the preserve of offshore hedge funds. In fact regulators across the world have started to liberalise their funds regimes to permit the establishment of alternative investment funds for promotion to the more sophisticated and/or high net worth (the two do not always necessarily go together) investor, conscious of the economic need for an investment product which can produce returns and protect capital in adverse markets where traditional long only funds simply follow the market down.

By way of example, in only the last year the Irish have introduced a retail hedge fund of funds, the cautious Luxemburgers have relaxed their alternative funds regime, and now the Germans have aired proposals for fund legislation which would embrace the alternative investment fund and, subject to certain conditions and caveats, permit its sale to the private investor. As London is the key European centre for alternative fund management, FSA's New Fund offers an opportunity for the UK to consolidate this position.

Features of the New Fund

Turning now to the nub of the issue, the characteristics of the New Fund, the principal ones are:

- It would be for subscription/promotion only by/to market counterparties and intermediate customers, including expert private customers who have secured classification as intermediate customers;
- Annual and half yearly reports will need to be provided;
- Performance fees will be permitted;
- Assets can include transferable securities, derivatives, cash, money market instruments, other funds, gold, real estate, precious metals and commodities contracts traded on a recognised exchange;
- The spread of risk is to be as specified in the prospectus;
- Short selling will be permitted subject to global cover;

- Borrowing will be allowed up to 100% of NAV subject to adequate cover; and
- Limited redemption and limited issue will be permitted.

Non-retail funds would be subject to the core requirements for all authorised funds, including:

- having an independent, regulated depositary and a regulated operator;
- regular pricing;
- investments to be made for the purposes of spreading investment risk;
- appropriate disclosure about the fund;
- the right of investors to determine fundamental matters concerning the operation of the fund; and
- conflicts of interest must be managed in the investors' interests.

The FSA is in discussions with the UK Inland Revenue concerning the taxation of these new funds.

Will the advent of the New Fund change anything?

The temptation is to see these proposals at first blush as carte blanche for allowing the establishment of hedge funds for sale to the sophisticated public in the UK who have hitherto been largely prevented from investing in hedge funds thanks to arcane and partly illogical, complex promotion rules relating to unregulated CIS's. However, there are two barriers to that.

First, as mentioned above, the tax question needs to be resolved. The current tax regime will be less favourable to a domestic hedge fund deploying short selling and leverage than to a fund with an identical investment style based offshore. For this reason alone the traditional, small boutique fund manager will note the proposals with academic interest only.

Second, specialist hedge fund managers do not have the administration systems and retail client network to promote an authorised fund, for even though the New Fund contains hedge fund friendly features like performance fees, leverage and short selling, it is framed within the FSA's authorised fund regime and therefore subject to the requirements listed above, such as having a regulated depositary. Notwithstanding the streamlining and slimming of the CIS regulations, compliance with authorised fund regulations is no tea party, and involves significantly more than is the case under the benign FSA regime for the typical hedge fund manager.

However, on the plus side, as an FSA authorised fund the New Fund as a regulated fund can circumvent the promotion of unregulated funds rules and be promoted subject to the FSA paramaters above, *e.g.* to intermediate and expert private investors classified as such. This is a significant advantage, even though FSA is looking into the inconsistencies of the unregulated fund promotion regime.

For these reasons the New Fund is likely to find fertile ground in the terrain of existing authorised fund managers for whom it will be an opportunity to innovate and diversify, using their existing compliance, administration and distribution facilities: likewise the larger management groups who already provide onshore and offshore funds. In particular managers will no longer need to accommodate institutional investors in a separate share class alongside the retail class. There has always been an element of square peg in round hole about this. The New Fund should prove a remedy to this conundrum. It will be interesting to see how the proposals are received by the fund management industry.

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