

# United Kingdom

## Regulation

HEDGE FUNDS 2009

### Hedge fund managers/advisors

#### Regulation

##### Authorization requirements and process

United Kingdom hedge fund managers and advisors are typically required to seek authorization under the Financial Services and Markets Act 2000 (FSMA2000) by the Financial Services Authority (FSA) prior to commencement of business. FSMA2000 sets out the instruments, activities and services which require prior authorization. The activities and services include, but are not limited to: dealing in investments as agent on behalf of clients; managing investments on behalf of clients; advising clients on investments; and establishing, managing, operating, or winding up a collective investment scheme. Investments include: shares, warrants, debt instruments, units, and various derivative products (including futures, options, and contracts for difference).

Once a firm has established that it requires FSA authorization for the activities it intends to carry out, it should complete the FSA's authorization pack available from the FSA website. The application pack comprises a number of different detailed forms which require the applicant to provide information, the purpose of which is to demonstrate that it meets threshold conditions for being an authorized person under FSMA2000. There is also an extensive amount of supplementary documentation required including legal agreements, financial and regulatory capital forecasts, and the work history/experience of the senior individuals expected to be part of the applicant firm's business.

Once submitted, the application is processed by the FSA. There is often engagement between the FSA and the applicant during this process during which questions are raised and issues identified. Once these matters are satisfactorily resolved the application is taken to the FSA's approvals committee.

### Typical timescale to receive approval

The FSA has an internal service standard of making decisions on applications within approximately four months. Straightforward applications may be dealt with faster and more complex applications may take longer.

### Regulatory capital requirements

The minimum regulatory capital requirements for hedge fund managers depend on its activities but for most the requirements will be based on the Capital Requirements Directive (CRD) as set out in the FSA's GENPRU and BIPRU sourcebooks.

On the basis that the firm is limited license its minimum regulatory capital requirement (Pillar 1) is the highest of three different calculations as set out below.

Base requirement of EUR 50,000/ EUR 125,000 depending on whether the firm is permitted to hold client money and/or assets;

Sum of credit risk and market risk requirements; and

Fixed Overheads Requirement of one quarter (25 percent) of relevant annual expenditure. Discretionary bonuses and commissions are deducted in the calculation of relevant annual expenditure.

Often the highest of these three calculations is the Fixed Overhead Requirement.

In addition to these minimum capital requirements, limited license firms currently have to comply with concentration rules which prevent the firm from having an exposure to a single counterparty, or a group of connected counterparties, greater than 25 percent of its capital. This can often give rise to problems in relation to management and performance fees receivable and there is currently consultation at the European level to remove limited license firms from the scope of the concentration rules. A decision is expected in quarter two of 2009.

Limited license firms also have to comply with the Pillar 2 requirements of the CRD. These require an assessment by management of the risks of the business to its capital and may result in the firm having to hold capital in excess of the Pillar 1 minimum amount. This process is also known as the 'Internal Capital Adequacy Assessment Process' or ICAAP and it is subject to challenge by the FSA.

#### Significant restrictions on marketing to investors

There is a general prohibition on the promotion of unregulated collective investment schemes (the most common form of hedge fund) to the general public. However, under the conduct of business rules for the promotion of unregulated collective investment schemes, the fund may be promoted to a potential investor where the firm making the promotion has sufficient understanding of an individual's wealth and risk appetite and the customer meets the criteria for being an elective professional client and has been accepted as such. Client categorization is dealt with in the FSA's Conduct of Business Sourcebook (COBS). COBS 3, section 3.5 covers professional clients. COBS 4.12 deals with invitation and inducement to participate in an unregulated collective investment scheme without breaching the FSMA2000. COBS 18.5 deals with operators of collective investment schemes and includes the regulatory requirements for unregulated collective investment schemes.

There is a general requirement that financial promotions should be fair, clear and not misleading. Additionally, the FSA expects the risks and rewards of a product or service to be given equal prominence.

#### Hedge fund structures

#### Regulation

##### Authorization requirements

In order for a fund to be regulated (or in certain situations recognized) by the FSA, it would have to meet the conditions and requirements of the FSA Handbook. Generally, the FSA expects a regulated fund to be managed by an Authorized Person in the United Kingdom.

The FSA's Collective Investment Schemes' Rules (COLL) provide for UCITS schemes, Non-UCITS retail funds and Qualified Investor Schemes (QIS). The UCITS III and COLL Rules allow for the use derivatives in authorized funds. Therefore funds can adopt some characteristics of hedge funds and these funds can be promoted to the general public. However, the permitted investments and substantial constraints on borrowing mean that it is not possible to obtain authorization of a retail hedge fund in the United Kingdom.

Over the past two years, the FSA have consulted on an extension of its COLL Rules to permit Non-UCITS retail schemes to invest up to 100 percent in unregulated collective investment schemes. These prospective schemes are referred to as Funds of Alternative Investment Funds (or FAIFs). The regime has not yet been finalized and introduced because there have been a number of tax issues to resolve in order that FAIFs are not compromised by the U.K. rules on the taxation of funds. The U.K. regime for taxation of funds is currently undergoing significant review and revision and this may resolve the taxation of

FAIFs. The current expectation is that the FSA will finalize and issue its rules for the Regulation of FAIFs in quarter two 2009, and, subject to a satisfactory tax regime for such, funds to be efficient for investors, in principle funds of hedge funds, could be established in the United Kingdom in the second half of 2009.

### **Restrictions on types of investments, concentration levels, and the manner in which hedge funds can invest and/or strategies**

There is no regime in the United Kingdom for authorized hedge funds and so no rules on investments and other constraints.

When FAIFs are permitted in 2009, there will be principles based restrictions, substantial manager due diligence requirements, and potentially a number of hard limits on concentration of investment, use of leverage, notice of dealing and maximum period to settle redemptions. For example, FAIFs will only be permitted permanent borrowing of up to 10 percent of the NAV so they will not be leveraged at the fund level.

The U.K. rules for authorized funds do permit the use of derivatives as established by the UCITS III amendments to the UCITS Directive. Positions must be covered globally; there can be no net liabilities created; and there are constraints on borrowing (leverage) therefore any hedge fund like strategies are constrained in U.K. authorized funds. That said, a number of U.K. UCITS funds have been established using what are sometimes referred to as hedge fund light strategies to provide managed returns for investors.

### **Rules regarding the publishing of the accounts and prospectuses**

Other than in respect of regulated/recognized schemes, there are no rules regarding the publishing of accounts and prospectuses of collective investment schemes. However COBS 18.5.10 and 18.5.11 address the requirements for provision of adequate information, including period statements, to investors in unregulated schemes. COBS 18.5.13 provides for exceptions to provision of period statements.

Hedge funds listed onto an exchange such as AIM will need to comply with listing requirements in their prospectus and prepare accounts in accordance with U.K. Financial Reporting Standards. More commonly, the favored listing route is via the Irish Stock Exchange necessitating compliance with their listing requirements.

### **Time-scale of establishment of a hedge fund**

Not applicable as there is no authorization regime for hedge funds in the United Kingdom.

## Investors

### Regulation

#### Restrictions on which type of investors can invest in a hedge fund and/or the minimum/maximum number of investors in a hedge fund

There are no restrictions on the maximum or minimum numbers of investors. However, if the fund is U.K. authorized, then it must be open to all investors notwithstanding any prospectus minimum subscription requirements.

There is a general prohibition of the promotion of unregulated schemes to the general public regardless of whether it is a hedge fund or not. If the fund is not authorized or recognized by the FSA, then this prohibition applies. A manager may promote the fund to a specific retail customer where the firm making the promotion has sufficient understanding of an individual's wealth and risk appetite and that the customer understands the risks involved. Client categorization is dealt with in the FSA's Conduct of Business Sourcebook (COBS). COBS 3, section 3.5 covers professional clients and COBS 18.5 includes the regulatory requirements for unregulated collective investment schemes.

The FSA has proposed that its rules for FAIFs will include rules requiring a Genuine Diversity of Ownership. This will reinforce the principles based requirement that authorized funds are open to relevant shareholders, appropriately marketed to the target market, and that there are not inappropriate barriers to purchasing units in an authorized fund.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.