

Vincent Mercer* looks at the regulatory state of play for alternative investment funds

A long look forward

There can be no doubt that the alternative investment industry is growing exponentially. In a speech given in February, Dan Walters, an asset management sector leader for Financial Services Authority (FSA) announced that FSA recognised some 160 specialist hedge fund managers, with another 90 fund managers having added a hedge fund mandate to their existing suite of regulatory permissions. FSA estimates that, on aggregate, around \$250 billion of hedge fund equity is being serviced in the UK.

Walters also cited a recent survey of the market, which revealed that the UK is the leading European centre for hedge fund management with some 70% of European based hedge managers. He mentioned that, according to hedge fund database TASS, the US remains the largest centre for hedge fund managers, with some 70% of the global market putting the UK second only to the US in terms of hedge fund management.

The problem for FSA is that in a typical hedge fund structure, while the manager will be based in the UK, the fund they manage is not. Typically, the fund will be domiciled in a tax efficient jurisdiction (like Bermuda, Cayman Islands or BVI) with the fund's administration and safe custody being provided from Dublin, the Channel Islands or Luxembourg.

UK regulation was developed to deal with unit trusts and their trustees and more recently open ended investment companies and their depositories. This dates back to the origins of regulation in the Financial Services Act 1986 in which the then funds industry persuaded the then government that only their products should be made freely available to investors in the UK.

When dealing with hedge funds it emerges that FSA (and regulators internationally) are handicapped by rules based on outdated principles, jurisdictional issues and in many

cases have no real understanding of what they are actually dealing with.

For the hedge fund community, the current state of UK regulation gives it real difficulties, particularly when it comes to promoting hedge funds in the UK to private (retail) investors. Most hedge fund investment opportunities are only widely available to private investors through some form of 'wrapper'. This is typically either through a structured product or, more recently, fund of hedge funds closed end investment trusts (FSA rules prohibit single manager hedge funds from listing on London Stock Exchange). These products are available to investors with as little as £10,000 (\$18,000) to invest. There are a growing number of these closed end listed fund hedge funds backed by the likes of HSBC and Man, with Dexion now offering listed fund of hedge funds on a consultancy basis.

Difficulty

The difficulty for these offerings is the additional layer of costs involved. The banks offering the structured bond or note will want to pass on the costs of developing the structure and be compensated for the risks of acting as issuer and in some cases guarantor of the products. In the case of listed closed end fund of hedge funds, it is not just the legal costs and the costs of compliance with the listing requirements, it also involves the costs of a marketing agent and a listing sponsor, as well as the usual set up costs for custodians and administrators.

The traditional funds community also has problems with the current state of regulation. Over time, the rules they promoted in the mid-80s are now an impediment to them providing investors with meaningful returns in the markets we have experienced over the past few years. Increasingly, traditional fund providers have been forced to look at

alternative investments as a means of generating returns for their investors.

As Dan Waters noted, there are 60 traditional fund managers that FSA recognises as moving into the alternative fund management space. We have recently seen Morley, the investment arm of UK insurance group Aviva, announcing that it is set to be one of the first investment managers to set up a retail fund that would use an actively managed long/short investment strategy using derivatives to make gains for investors.

Not only are we seeing such innovations among individual managers, we are seeing tectonic changes throughout the traditional funds community. For example, Investment Managers Association, the bastion of the traditional fund management community, is having problems with its sector categorisation system as it comes to terms with something the alternative investment community has known for a long time – it's difficult to pigeon hole a fund.

As ever, if you want to know what's happening, look to the back office. As the traditional funds community has been snapping up alternative investment expertise, we have seen a raft of acquisitions of alternative investment administrators by established safe custody players such as the Northern Trust acquisition of Barring Asset Management FSG, Melon acquiring DPM, the US based hedge fund administrator, while HSBC has gone one further by buying Bank of Bermuda. The logic behind these acquisitions has not been to gain funds under management, but to gain expertise in the alternative investment space.

Regulators reaction

Against this background, the developing European single market in financial services includes a move to provide the flexibility that both the alternative investment and traditional investment

communities need to develop modern products for investors.

UCITS II and UCITS III (both amending the original UCITS Directive of 1985), are due to be implemented in every European Union member state by February 2007. UCITS II (the 'management' directive), introduced rules designed to harmonise market access and operating conditions (for example, capital requirements), set uniform safeguards for UCITS management companies and allow them not only to manage collective investment schemes but also portfolios. The idea behind it is to give management companies the same rights as other financial services organisations such as banks, insurance companies and investment firms under the investment services directive.

UCITS III (the 'product' directive), meanwhile, was designed to increase the flexibility of investment products which could be offered as UCITS scheme allowing a mixing of asset classes and allow derivatives to be used for investment purposes.

Particularly in relation to the use of derivatives, the scope of UCITS III was unclear. As part of the implementation of the directive, the Commission established an expert working party to try and sort out some of these issues. It published its recommendations in April 2004, recommending a limit on a UCITS fund's exposure to derivatives of 200% of its net asset value and limiting short exposure to cash settlement.

In response to these initiatives, FSA developed new rules, commonly referred to as COLL (the collective investment scheme sourcebook), designed to simplify the UK fund regime so that by 1 February 2007, every UK fund should ideally be compliant with UCITS III. However, FSA has gone further, with additional classes of scheme including a new non-UCITS qualified

investor scheme (QIS). A QIS fund is aimed at "sophisticated investors" (intermediate customers and market counterparties) and is designed to allow significant flexibility in the investment objectives of the fund. However, unlike UCITS schemes it cannot benefit from a European passport. There is a cap on total exposure to derivatives to the fund's net asset value. Uncertainty over the tax treatment of returns gained by a QIS fund have delayed their uptake, but the Treasury recently clarified the position and FSA has apparently now approved its first QIS fund.

What happens next?

Many traditional investment management groups have already converted their funds to be compliant with COLL and UCITS but all must do so by February 2007. However, there are some practical problems to overcome. For example, if a fund wanted to take advantage of a more flexible or wider investment mandate there may be notification requirements or indeed a requirement for unit holder consents depending on the constitution of the fund.

Committee of European Securities Regulators (CESR) is also on the case and is currently seeking comments on draft advice on the implementation of UCITS and further changes that may be needed to the UCITS Directive. This exercise is due to be complete in March 2006. However, a green paper is expected this autumn, which will address a wide range of asset management issues including the treatment of hedge funds.

Meanwhile, FSA is moving forward with its own initiative on the introduction of hedge funds, and its business plan for 2005/6 proposes the issue of a discussion paper on hedge funds during 2005, which should see the paper being launched this summer. While FSA is considering its position, as it stands, hedge funds

cannot be promoted to retail investors under the Financial Promotions Order and any change in the Order will require Treasury consent.

As the traditional and alternative investment communities move towards each other, the regulators are finding that they need to greatly improve their understanding of alternative investment. In his speech, Walters said FSA had initiated a programme based around prime brokers to get what he described as, "a better handle on these overall flows and the levels of leverage implied". Waters went on to say that FSA's work was to extend beyond the prime brokers so hedge fund managers may well find FSA asking them for information.

In fact, FSA is not alone. As part of the same trend, in the US, Securities & Exchange Commission (SEC) has made changes to the Investment Advisors Act 1940, which will require all but the very smallest hedge fund managers to register and report to SEC. The move has been brought about by SEC's need to gain more information about the alternative investment industry. In justifying the move, SEC claims that it has been brought about by the broader exposure to hedge funds by smaller investors, pensioners and other market participants directly and to prevent fraud.

As ever with regulatory matters, we are in a constant state of change not only in the UK but across the whole of Europe and, indeed, internationally. Now this change is being driven at least in part by the regulators' acceptance that hedge funds and alternative investments are going to be part of the product range and should be treated in the same way as other fund products. □

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