FSA Announces New Rules for Funds of Alternative Investment Funds

On 26 February 2010, the FSA published Policy Statement ("PS") 10/3, "Funds of Alternative Investment Funds ("FAIFs")". This much-delayed paper responds to a consultation that took place in February 2008 on certain aspects of FAIFs; indeed, the original consultation on introducing FAIFs dates back to March 2007. The FSA gives no reason for the delay, but since the success of the FAIFs regime will depend on appropriate taxation regulations, one might guess that at least some of the delay (outside the global credit crisis) has been taken up in developing such regulations with HM Treasury and HM Revenue and Customs. Indeed, as noted below, new taxation regulations will come into force at the same time as the new FAIFs regime, on 6 March 2010.

FAIFs are a type of non-UCITS scheme that may be marketed to retail investors (such schemes are known in the FSA rules as "NURS"). Although, like other NURS, FAIFs are subject to various investment restrictions (such as a restriction on the type of investments that can be made and on their OTC derivative exposure), they will operate under a more relaxed regime. In particular, FAIFs will be able to invest up to 100% of the scheme property in collective investment schemes that satisfy specified requirements, and to invest in a single master scheme.

PS 10/3 sets out the FSA's responses to five questions raised in the February 2008 consultation:

1. **Repayment standards.** The original FSA proposal to use existing repayment standards (including payment for a redeemed unit within four business days following redemption) has been significantly amended, in response to comments that such a proposal would have made the operation of FAIFs unworkable. Fund managers now have up to 185 days to pay redemptions from the receipt and acceptance of an instruction to redeem. Details of the redemption procedure must be disclosed in the FAIF documentation so that the investor fully understands the arrangements. This is particularly important given that FAIFs can be marketed to retail investors.
2. **Master/feeder structures.** Unsurprisingly, the proposal allowing master/feeder structures received widespread support. However, the FSA has concluded that where a master/feeder structure is used to achieve the FAIF's objectives, the master fund, being a substitute for the feeder fund, must abide by the rules of the feeder scheme; if this were not done, the master scheme could be used to circumvent the restrictions on the feeder scheme. The feeder fund's manager is therefore responsible for ensuring that the master fund abides by the rules in FSA's Collective Investment Schemes sourcebook ("COLL"), and will be potentially liable for any failure.
3. **Strengthened due diligence approach.** The majority of respondents agreed with the FSA's proposals in this area (which have been supported by events since the original consultation, notably the Madoff frauds). The FSA has decided to go further than originally proposed, and strengthen requirements in relation to custody and valuation. Consequently, a FAIF manager is required to carry out initial and ongoing due diligence, both to determine that the property of the underlying scheme is held by an independent third party, and to ensure that the calculation of an underlying firm's NAV and the maintenance of its accounting records are segregated from the scheme's investment management function.

4. **Genuine diversity of ownership ("GDO")**. FSA had originally proposed that COLL should contain provisions requiring any FAIF to have GDO built into its trust deed/instrument of incorporation and repeated in its prospectus. However, pursuant to new tax regulations concurrently coming into effect with FSA's FAIFs rules, FAIFs with investments in non-reporting offshore funds (such FAIFs are termed "Funds Investing in Non-Reporting Funds" or "FINROFs" under the new tax regulations) are subject to special treatment. Where such investments exceed 20% of the FAIF's gross asset value, or alternatively where the FAIF makes an election, the FAIF will not be subject to tax on gains realised from investments in such non-reporting offshore funds, so long as certain conditions are satisfied. Instead, the investors in the FINROF will be taxed on income in relation to any gains made on disposal of their respective interests in the FINROF.

   Given that the GDO condition has been designed for funds that want to offer capital treatment to investors for trading transactions, and that investors in FAIFs that qualify as FINROFs will be taxed to income on their entire gain (including investments that would otherwise have resulted in capital treatment), the FSA has concluded that GDO requirements in COLL are no longer necessary.

5. **Cost-benefit analysis.** FSA received no comments on the cost-benefit analysis on which it consulted. The FSA points out that the feedback it has received suggests that the costs of developing the systems capable of handling dealing and repayment frequencies of up to 185 days are in the region of £500,000, though the exact amount will vary from firm to firm. These and other additional costs may, as the FSA concedes, deter some firms from entering the FAIF market, although it might be possible for some of the costs to be passed on to the FAIFs themselves, rather than being borne by the firms.

As noted above, as FAIFs are a type of NURS, they will be subject to certain spread restrictions set out in COLL 5.7.5R. The FSA has rejected the argument put forward (in particular by hedge fund managers) that an increase in leverage limits from 10% of NAV would be necessary to manage fund liquidity. Nor has it accepted that the rules should be changed to widen the scope of investment in commodities (currently up to 10% of the fund can be invested in only one commodity, gold), though its comments suggest that it recognises that this is illogical.

The FSA also notes that the proposed Alternative Investment Fund Managers Directive ("AIFMD"), the text of which is currently being negotiated, may have an impact on the FAIFs regime. This is because the scope of the AIFMD may, once the text is finally agreed upon, cover NURS currently operated by individual Member States, and thus restrict the scope of those Member States to make their own rules (as well as requiring them to amend their existing rules). However, given that there is considerable uncertainty as to what the final text of the AIFMD might be, the FSA has decided to bring the FAIF rules in at this point in time, rather than wait for that uncertainty to be resolved.

The FSA has indicated that once a sufficient number of FAIFs have been established, it will conduct a post-implementation review into the working of the rules, to see whether the FSA's desired policy outcomes are being achieved.

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