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A NEW APPROACH TO FUND REGULATION IN THE UNITED KINGDOM

The Financial Services Authority (FSA) has proposed radical changes to fund regulation in the United Kingdom that would create a two-tier regime based on investor qualifications. Reflecting the existing division within the industry between "institutional" and "retail", the proposals would bring certain non-retail funds within the FSA's ambit for the first time.

Consultation Paper 185, '*The CIS Sourcebook – a new approach*' (CP 185) puts forward the most comprehensive revision of the collective investment scheme (CIS) regime since 1991. Both retail investors and professional investors would benefit; the former through access to a wider range of products and the latter through significant reduced regulation.

By the FSA's own estimate its 500 page CIS Sourcebook, which has expanded haphazardly over the past decade in response to unforeseen market events and rapid product evolution, could be reduced by as much as 40%. The balance would fundamentally shift from a restrictive regulation-focused approach to a more liberal documentation-focused approach, from "one size fits all" thinking towards a recognition that investors have different levels of expertise and experience. The willingness of the FSA to remove unnecessary layers of accumulated regulation and re-establish an appropriate legal baseline for authorised CISs has been welcomed by the industry.

First, a new category of schemes, within the FSA regime but subject to lighter regulation (and less consumer protections) than retail schemes, would be introduced for market counterparties and intermediate customers, as defined in the FSA's Conduct of Business Sourcebook. Certain expert private customers reclassified as intermediate customers would also be eligible to invest. The FSA expects such investors to accept a higher level of risk than retail customers. The new category would provide increased access to certain "hedge fund" strategies such as short selling, derivatives and leverage, although discretion in investment strategy would not be unlimited and product regulation would apply. Derivatives based on financial instruments and commodities would be permitted up to the net assets of the funds, as would leverage up to 100%. Suitable risk-based disclosure would be required in offering documents regarding how any particular scheme would operate. Ordinary hedge funds seeking to utilise the full spectrum of trading strategies, however, are expected to remain offshore.

Second, falling in line with the rest of the European Union, performance fees will be allowed for both unit trusts and open-ended investment companies (OEICs), provided adequate disclosure is provided for how these will operate in practice. In addition, rules with regards to unit trusts would continue to converge with OEICs. For example, multiple classes of units would be allowed in the same way that OEICs have multiple share classes, replacing the current offering of income, accumulation and limited issue units and possibly facilitating more innovative pricing structures.

Third, the quality of information provided the investors would be increased, as quantity of new information is cut back. Short form reports would be sent to investors instead of traditional long form reports and account, and prospectuses will generally become more user friendly. In addition, in place of current requirements to obtain investor approval on a variety of matters, CP 185 contains a simplified approach that categories proposed changes as follows:

(a) *Fundamental events* that would materially prejudice the investors and, therefore, require investor approval.

(b) *Significant events* that could reasonably be expected to cause investors to reconsider their investment in the fund and, therefore, require 60 days minimum notice.

(c) *Notifiable events* for which the fund's manager would decide how and when to notify investors.

Finally, retail investors in the United Kingdom will be given access to a new categories of CISs that fall outside of the EU passporting rights under Directive 85/611/EEC (the UCITS Directive), which would be able to have more concentrated portfolios and invest more in less liquid assets, such as property (currently outside the UCITS Directive). Two broad categories of retail funds, "UCITS" and "non-UCITS", will replace the eight current prescriptive categories. Where underlying investments of a CIS are relatively illiquid, redemption in the future may be limited to twice a year rather than twice a month, as is the case now. Restrictions preventing property funds from being wholly-invest in real estate would also be repealed.

The intention of the FSA is to give the UK investment management industry increased flexibility, enabling it to compete of level ground with other onshore and offshore

regimes, while simultaneously protecting investors and increasing investor choice. CP 185 falls within a global trend to liberalise the regulation of hedge funds and other alternate investment vehicles. Each of Hong Kong, Singapore, Ireland, the Netherlands, France and Germany have recently either implemented or announced far-reaching changes in this area.

Although FSA authorisation of a CIS provides increased levels of comfort for investors and intermediaries alike, the main barrier to bringing hedge funds strategies onshore remains the punitive UK tax regime. It is of primary importance, therefore, that the tax status of these new funds be clarified as soon as possible. Unaddressed by the Treasury, the proposed changes will be of little use, despite CP 185 enthusiastic reception by certain fund sponsors and intermediaries.

Under the current Inland Revenue taxation rules, gains arising in hedge funds are categorised as trading income, ineligible for tax relief and then taxed again in the hands of investors. The FSA has indicated that they have worked closely with the Inland Revenue, which would consult on changes to the tax regime shortly.

Alternative investment funds have historically been relegated to offshore jurisdictions as a result of inhospitable onshore tax and regulatory regimes. Certain European countries, such as Ireland and Luxembourg, have made increasing efforts over recent years to accommodate these products onshore. One measure of the success of CP 185, if adopted, will be whether or not fund sponsors begin to perceive the United Kingdom as a viable alternative to Ireland and Luxembourg. Efficiencies and cost savings are available to fund sponsors who offer a wider range of products in a single jurisdiction.

With the proposed two-tier, three category structure (UCITS qualifying funds, non-UCITS retail funds and non-retail funds), the FSA's modernised approach recognises different expertise of different investors, while enabling the industry – and the CIS Sourcebook – to better adapt to an evolving markets. As a result, intermediaries restricted from investing in (or merely uncomfortable with) unauthorised CISs will now be able to fully address the growing demand for such products by expert investors, such as UK insurance companies and pension funds who remain underweight in alternative strategies, unlike many of their US and European counterparts.

The consultation period for CP 185 ends on 31 October 2003. The FSA has indicated that final rules should be in place early 2004, initially on an extended transitional basis to February 2007, when the UCITS III product directive will come into force.

Timothy Spangler

Berwin Leighton Paisner

THE HAMLYN LECTURES 2003

The Hamlyn Trustees are pleased to announce the following public lectures and acknowledge with gratitude the support of Thomson, Sweet & Maxwell, the University of Exeter and Cardiff Law School

HONOURABLE JUSTICE MICHAEL KIRBY AC CMG

Justice of the High Court of Australia

on

JUDICIAL ACTIVISM

University of Exeter

Wednesday 19th November 2003 at 6pm

"Old Testament"

Venue: Parker Moot Room, Amory Building, University of Exeter, Rennes Drive, Exeter

Attendance: Open to the general public. Free Admission. To reserve a seat contact Liz Balloch, Marketing Secretary, School of Law, University of Exeter, Amory Building, Rennes Drive, Exeter EX4 4RJ. Tel: 01392-263366. Email: E.A.Balloch@Exeter.ac.uk

Thursday 20th November 2003 at 6pm

"Reformation"

Venue: Parker Moot Room, Amory Building, University of Exeter, Rennes Drive, Exeter

Attendance: Open to the general public. Free Admission. To reserve a seat contact Liz Balloch, Marketing Secretary, School of Law, University of Exeter, Amory Building, Rennes Drive, Exeter EX4 4RJ. Tel: 01392-263366. Email: E.A.Balloch@exeter.ac.uk

Cardiff Law School

Monday 24 November 2003 at 7pm

"Counter-Reformation"

Venue: Cardiff Law School, Museum Avenue, Cathays Park, Cardiff

Attendance: Open to the general public. Free admission by ticket only. Tickets available from Ms Penny Smith, Public Leture Series Co-ordinator, Cardiff Law School, Po Box 427, Cardiff CF10 3XJ (please include stamped address envelope). Email: smithp1@cardiff.ac.uk. Tel: 029 2087 5364. Fax: 029 2087 4097.

Tuesday 25 November 2003 at 7pm

"Concordat"

Venue: Cardiff Law School, Museum Avenue, Cathays Park, Cardiff

Attendance: Open to the general public. Free admission by ticket only. Tickets available from Ms Penny Smith, Public Leture Series Co-ordinator, Cardiff Law School, Po Box 427, Cardiff CF10 3XJ (please include stamped address envelope). Email: smithp1@cardiff.ac.uk. Tel: 029 2087 5364. Fax: 029 2087 4097.