UK (England and Wales)

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RETAIL FUNDS

1. Please give a brief overview of the retail funds market in your jurisdiction. (How developed is the market? Has it been active in the past year?)

Open-end retail funds

The open-end retail funds market in the UK is long standing (the first collective investment vehicles were introduced in 1931) and well developed. It consists of two main types of product:

- Authorised unit trusts (AUTs).
- Open-end investment companies (OEICS), which have only been able to be established in the UK since January 1997, but have now captured more than half of the open-end retail funds market.

According to figures published by the Investment Management Association (IMA), in April 2007 (April 2006 figures in brackets) total UK domiciled funds under management were GB£458.8 billion (about US$950.6 billion) (GB£386.2 billion (about US$800.1 billion)), of which GB£273.3 billion (about US$566.3 billion) (GB£245.5 billion (about US$508.7 billion)) were funds in OEICS. There were 2,080 (2,014) funds available, of which 1,329 (1,273) were OEICS. In total, 113 (115) companies provided AUTs and 80 (79) provided OEICS.

Closed-end retail funds

The closed-end retail funds market in the UK is also long established and the first investment company designed for retail investors was founded in 1868. As of 30 April 2007, the Association of Investment Companies (AIC) records that there were 429 investment companies with net assets of GB£93.4 billion (about US$193.5 billion) and a market capitalisation of GB£77.7 billion (about US$161 billion). The vast majority of these companies are conventional investment trusts, although there are some companies where there are different classes of shares with different entitlements (split capital investment trusts) and a smaller number of venture capital trusts. The market in 2007 has been very active, with over twenty new issues existing or planned at 30 April, which is more than double the number compared with the same period in 2006.

2. What are the key statutes, regulations and rules that govern retail funds in your jurisdiction? What regulatory bodies are involved in regulating retail funds?

Open-end retail funds

The key provisions are the:

- Financial Services and Markets Act 2000 (FSMA).
- Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.
- Open-Ended Investment Companies Regulations 2001 (OEICS Regulations).
- Rules contained in the Handbook of Rules and Guidance of the Financial Services Authority (FSA Rules), in particular the Collective Investment Schemes Sourcebook (COLL) and the New Conduct of Business Sourcebook (COBS). COBS came into force on 1 November 2007, and compared to its predecessor places a greater emphasis on principles rather than detailed requirements.

The relevant UK regulatory body is the Financial Services Authority (FSA), which regulates both the persons who manage the fund and (in so far as they are different) those who market the fund, as well as the person who acts as custodian or trustee of the fund's assets.

Closed-end retail funds

The key provisions are the:

- Companies Act 1985 and the Companies Act 2006 (the latter is being implemented in stages and will replace virtually all the provisions of the former by 1 October 2009).
- Income and Corporation Taxes Act 1988 (ICTA).
- Financial Services and Markets Act 2000.
- Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.
- Listing Rules, Prospectus Rules and Disclosure Rules in the FSA Rules (together the Listing Rules) and, in relation to marketing, COBS.

Country Q&A

The relevant UK regulatory bodies are:

- The FSA (for listing and marketing requirements).
- The Department for Business, Enterprise and Regulatory Reform (BERR) (for Companies Act requirements).
- HM Revenue and Customs (for taxation requirements).

3. Do the retail funds themselves have to be authorised or licensed? If so, what are the main steps involved?

Open-end retail funds

An open-end retail fund must be either an:

- **AUT scheme.** An application for authorisation must be made to the FSA using the appropriate application form, by the manager and trustee jointly, both of whom must be authorised persons. The application must also include:
  - a draft trust deed;
  - a solicitor's certificate;
  - a copy of the prospectus;
  - the appropriate application fee.

  Model trust deeds have been prepared by the IMA, which can be used as a basis for the application.

- **OEIC.** An application for authorisation must be made to the FSA using the appropriate application form, by the authorised corporate director (ACD) and depositary, both of whom must be authorised persons (*Regulations 12-17, OEICS Regulations*). The application must include:
  - a draft of the proposed instrument constituting the OEIC;
  - a solicitor's certificate;
  - a draft prospectus;
  - a checklist showing where the appropriate contents requirements of COLL are located;
  - the appropriate application fee.

  As with AUTs, the IMA has prepared model instruments, which can be used as a basis for the application. If authorised, the fund is designated as an investment company with variable capital (ICVC).

In both cases, the FSA has six months to decide whether to grant authorisation once it receives a completed application. In practice, the FSA aims to process a completed application that relates to a UCITS (Undertakings for Collective Investments in Transferable Securities) scheme (and which can accordingly be marketed across the European Economic Area (EEA) using the UCITS passport - that is, a mechanism that streamlines the application and approval route for marketing in other EU countries) within six weeks.

Closed-end retail funds

A UK-based investment trust is structured as a London-listed public limited company (PLC) and does not need to be authorised by the FSA. However, HM Revenue and Customs must approve it under section 842 of ICTA, if it is to be classified for tax purposes as an investment trust (*see Question 13*).

4. Who can market retail funds?

Open-end retail funds

The marketing of AUTs and OEICs is mainly carried out by authorised persons (or their appointed representatives) under the FSA's rules (in particular, the financial promotion rules contained in COBS 4). However, if an exemption exists in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (FPO), it is possible for an unauthorised person to market the fund.

Closed-end retail funds

The position is the same as for open-end retail funds (*see above, Open-end retail funds*).

5. To whom can retail funds be marketed?

Open-end retail funds

With one exception, UK open-end FSA authorised retail funds can be freely marketed to UK retail customers. (Local laws determine their wider marketability outside the UK, although AUTs and OEICS, which are also UCITS can be marketed across the EEA using the UCITS passport.)

The exception is where the fund is a qualified investor scheme (QIS) which can be marketed only to investors that meet certain sophistication requirements set out in COLL 8 Ann 1R (such as professional clients and expert retail clients) or where an exception exists in the FPO.

Closed-end retail funds

Investment trusts can be freely marketed to UK retail customers.

6. What are the key requirements that apply to managers/operators of retail funds?

Open-end retail funds

The manager of an AUT (and the ACD of an OEIC) is subject to the FSA Rules. These include COLL, which contains requirements relating to the day-to-day management of the fund (such as investment and borrowing powers, and operating duties and responsibilities), but also other more general provisions in the Senior Management Arrangements, Systems and Controls (SYSC) section of the FSA Rules. If the manager is involved in marketing the fund, COBS is also relevant.

Closed-end retail funds

Managers of investment trusts must be authorised by the FSA, therefore, they are subject to the FSA Rules. COLL is not relevant; however, other parts of the Handbook (such as SYSC and COBS) are. In addition, as managers of investment trusts are appointed by the board of directors (who, as directors of a PLC, remain responsible to shareholders for the management of the trust), they must satisfy the board that they are producing appropriate returns, or they may be replaced.

7. Who holds the portfolio of assets? What regulations are in place for its protection?

Open-end retail funds

The following hold the portfolio of assets:

- For an AUT: the trustee.
- For an OEIC: the depositary.

In practice, the role of each is the same. In both cases, the person holding the assets is independent from the manager of the scheme.

The powers and duties of the trustee or depositary are contained in COLL.

Closed-end retail funds

The assets of the investment trust are held by its custodian or nominee. There are no requirements for the custodian to be separate from the manager; a single firm can act as both manager and custodian. The custodian must be authorised by the FSA and is subject to the FSA Rules, in particular the rules relating to custody in the Clients Assets Sourcebook (CASS).

8. What are the main legal vehicles used to set up a retail fund and what are the key advantages and disadvantages of using these structures? What are the participants' interests in the fund called (for example, share or unit)?

Open-end retail funds

An AUT must be established through a trust deed between the manager and trustee. An OEIC is created through an instrument of incorporation and enters into separate agreements with the ACD and the depositary.

An AUT and an OEIC share a common advantage, in that investors can sell their investments back to the manager (their units in the case of AUTs, their shares in the case of OEICS) at a price related to the net asset value (NAV) of the property to which the investments relate. This makes open-end retail funds attractive to investors. A further advantage for managers is that if the AUT or OEIC satisfies the requirements of Directive 85/611/EEC on UCITS, it can be marketed throughout the EEA using the UCITS passport.

An OEIC can be structured with several sub-funds, each with a different investment objective (for example, geographical or sectoral), therefore providing investors with the opportunity, within the same fund, to tailor their investment requirements and, when those requirements change, to switch easily between sub-funds.

A similar structure can be created by means of an umbrella AUT (that is, an AUT which pools its assets into separate parts, or sub-funds), but less economically. This aspect of an OEIC may in part account for its growing popularity with investors (*see Question 1*), as may the fact that shares in an OEIC are single-priced, unlike units in an AUT, where there is a spread between buy and sell prices.

Closed-end retail funds

A UK closed-end retail fund is invariably set up as an investment trust structured as a PLC established under the Companies Act (specifically as an investment company (*section 266, Companies Act 1985*)). Shares of investment trusts are listed and traded on the London Stock Exchange's Main Market (investment companies can also be quoted on the Alternative Investment Market (AIM), but they do not then qualify for investment trust status).

There are two main advantages to investment trusts for the investment manager:

- There is no requirement for FSA authorisation; therefore, there are no ongoing regulatory costs or restrictions that mirror those for open-end retail funds. For example, an investment trust's ability to borrow for investment is restricted not by FSA Rules, but by the limitations in its memorandum and articles of association which can be amended by the shareholders in a general meeting. However, an investment company must satisfy certain statutory requirements, such as limiting its individual holdings in companies that are not investment companies to 15% of its investments.
- Buying and selling investment trust shares has no effect on the amount of money available to the manager for investment, or on the investment portfolio, because an investment trust's shares are traded on a market. Therefore, the manager can pursue his investment policy and not be forced to sell assets to meet investor redemptions.

However, there is also a serious disadvantage with this structure. Shares of investment trusts are subject to the vagaries of the market, therefore the market price of a share may be less than the NAV attributable to that share. This can make investment trusts unattractive to investors. In addition, although investment trusts themselves are not subject to regulation by the FSA as investments, they are, as listed companies, subject to the continuing obligations of the FSA's Listing Rules (as well as to the requirements of general company law), so they do not escape the burden of regulation.

9. Describe the investment and borrowing restrictions to which retail funds are subject.

Open-end retail funds

Detailed investment and borrowing restrictions applying to open-end retail funds (AUTS and OEICS) are set out in COLL 5.

UCITS. For an open-end retail fund that is also a UCITS scheme, the restrictions include the following:

- Generally, no more than 5% of the fund's property can be invested in transferable securities or money market instruments of the same issuer.
- No more than 20% of the fund's property can be invested in transferable securities or money market instruments of entities in the same group.
- No more than 20% of the fund's property can be invested in a single collective investment scheme, with investment in non-UCITS schemes generally restricted to 30%.
- Maximum over-the-counter exposure is limited to 5% of the fund's property (this is increased to 10% where the counterparty is an approved bank).
- No more than 35% of the fund's property can be invested in government or public securities without restriction. If more than 35% is invested:
  - there is a limit relating to any single issue of 30% of the fund's property;
  - the securities must come from at least six different issues; and
  - prescribed disclosures must be made in the fund prospectus.
- Borrowing must not, on any one day, exceed 10% of the value of the property of the fund, and must be repayable out of the fund's property.
- Borrowing must be from approved banks or eligible institutions (as defined by the FSA) and must not be outstanding for more than three months without the consent of the trustee or depositary.

Non-UCITS. For an open-end retail fund that is not a UCITS scheme, different restrictions apply. However, generally, the investment and borrowing requirements give the manager more flexibility (for example, the manager may invest up to 10% of the fund property in gold, which is not possible for a UCITS scheme). The restrictions include the following:

- Generally, no more than 10% of the fund's property can be invested in transferable securities or money market instruments of the same issuer (this can be raised to 20% if the investment is in a collective investment scheme, the aim of which is to replicate the performance or composition of an index).
- No more than 20% of the fund's property can be deposited with a single body.
- No more than 35% of the fund's property can be invested in a single collective investment scheme.
- Maximum over-the-counter exposure to any one counterparty in respect of a derivatives transaction is limited to 10% of the fund property.
- Borrowing must not, on any one day, exceed 10% of the value of the fund's property, and must be repayable out of the property of the fund (but, unlike a UCITS scheme, there is no time limit on repaying the borrowing).

QIS. QISs are subject to less extensive investment and borrowing restrictions, reflecting the more sophisticated nature of their investors. For example, the manager can borrow up to 100% of the value of the fund's property, and can invest in derivatives provided that the maximum exposure is at all times covered by the fund's property.

Closed-end retail funds

Unlike open-end funds, investment trusts and investment companies are not subject to any FSA limitations on their ability to invest or borrow. However, they are subject to restrictions from a variety of other sources:

- The memorandum and articles of association may set out sectoral limitations on where the investment trust can invest.
- The prospectus may contain undertakings as to the limits that the investment manager must apply, particularly as to borrowing.
- For investment trusts, section 266 of the Companies Act 1985 includes, among others, a restriction on individual investments in companies (other than investment companies) of 15% of the total value of the investment company's investments.
- For investment trusts, section 842 of ICTA, includes, among others, a similar limitation to that for investment companies.
- The general obligation on the investment manager under the FSA Rules to manage investments in a prudent manner and have an appropriate spread of risk.

10. Can the manager/operator place any restrictions on the issue and redemption of interests in retail funds?

Open-end retail funds

The issue or redemption of interests in open-end retail funds (AUTs and OEICS) is governed by COLL. Generally, issue and redemption must be available throughout the dealing day. Only in exceptional circumstances can the manager or ACD suspend the issue and redemption of interests in the fund. COLL 7.2 requires that the:

- Trustee or depositary approves the suspension.
- Manager or ACD is satisfied that it is in the interest of all the fund's investors to suspend dealings.
- FSA is informed and provided with a written account of the reasons for the suspension.
- Suspension is lifted as soon as possible after the exceptional circumstances cease to apply, and in any event within 28 days of the start of the suspension.

For a non-UCITS retail scheme (NURS), redemptions can be restricted to one in every six months.

Closed-end retail funds

As investment trust shares are traded on a stock market, the investment manager has no influence over the buying or the selling of the shares once they are in issue.

11. Describe any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties.

Open-end retail funds

AUT. A holder of a unit in an AUT can transfer that unit to a third party, if the transfer is in a form approved by the person keeping the register and is permitted by the trust deed (*COLL 6.4.6R*).

OEIC. Shares in an OEIC can be transferred to third parties, if this is not prohibited or restricted by the prospectus.

Closed-end retail funds

As the shares of investment trusts are freely traded on the stock market, there can be no restrictions on the rights of shareholders to transfer or assign their interests to third parties.

12. Describe the periodic reporting requirements to:

- **Investors.**
- **Regulators.**

Open-end retail funds

- **Investors.** The manager (of an AUT) or ACD (of an OEIC) must prepare and send a short report to unitholders or shareholders every six months and produce a longer report every 12 months, which must be made available on request (*COLL 4.5*). The short report must contain, among other things, a review of the investment activity and performance and any other significant information that would enable unitholders or shareholders to make an informed judgement about the activities of the fund during the period.
- **Regulators.** Trustees of AUTs and depositaries of OEICS must make quarterly reports to the FSA, and investment managers must make quarterly and annual returns (there are different returns to make depending on whether the fund managed is a UCITS scheme or not) (*FSA's Supervision Manual (SUP)*). An OEIC's annual report must be delivered to the FSA.

Closed-end retail funds

- **Investors.** Investment trusts must report twice a year to shareholders, with a long report every 12 months. The reports must meet the requirements of chapter 9 of FSA's Listing Rules.
- **Regulators.** As companies, investment trusts must file an annual report and accounts with the Registrar of Companies, which must satisfy the provisions of FSA's Listing Rules. In addition, listed companies must make special declarations to HM Revenue and Customs.

13. Describe the tax treatment for:

- **Funds.**
- **Resident investors.**
- **Non-resident investors.**

Open-end retail funds

- **Funds.** AUTs and OEICs are exempt from taxation on their capital gains, but must pay tax on the income received by the fund. In practice, the tax payable is minimal after deduction of expenses.
- **Resident investors.** The taxation of unit trusts and OEICs is identical as far as the investor is concerned.

  UK-authorised unit trusts and open-ended investment companies can pay either dividends or interest. Investors must pay income tax on dividend and interest distributions, and capital gains tax on realised gains, subject to the usual allowances.

  Dividends paid by UK-authorised unit trusts and open-ended investment companies to resident UK investors are treated in the same way as dividends from ordinary UK companies, that is, additional tax is payable on this income if the investor is a higher rate taxpayer, and a repayment of tax can be claimed if the investor is a non-taxpayer.

  Interest distributions paid by UK authorised unit trusts and open-ended investment companies are treated in exactly the same way as interest on bank, building society and local authority savings. A UK resident individual cannot arrange for interest from AUTs or OEICs to be paid gross, but can claim a repayment of tax deducted if his circumstances allow.
- **Non-resident investors.** Non-resident investors are subject to local taxation requirements on any capital gains or income received. They may be able to take advantage of any double taxation arrangements in place between their country of residence and the UK, and arrange for interest or dividends to be paid gross.

Closed-end retail funds

- **Funds.** As with open-end funds, an investment trust does not pay capital gains tax on gains on its investments, however it is subject to taxation on any income it receives (*see above, Open-end retail funds*).

- **Resident investors.** The position is the same as for an open-end fund (*see above, Open-end retail funds*).

- **Non-resident investors.** The position is the same as for an open-end fund (*see above, Open-end retail funds*).

14. Please summarise any proposals for the reform of retail fund regulation in your jurisdiction.

In March 2007, the FSA issued proposals to introduce retail funds of alternative investment funds (FAIFs). Under these proposals, funds that do not qualify as UCITS schemes can invest 100% of the fund's property in unregulated collective investment schemes. However, the manager must exercise a due diligence approach when investing more than 20% of the fund's property in these schemes. A controversial feature of the proposal is that there is no requirement for independent verification of the value of assets of the target schemes. In addition, redemptions may be as rare as once every six months. Consultation for this closed on 27 June 2007.

At the same time, HM Treasury is proposing to modernise the offshore funds tax regime to remove the barriers that currently prevent the development of offshore funds of funds, and issued a consultation paper on this subject in October 2007.

The FSA has indicated that it will not publish its final rules in relation to FAIFs until the taxation position becomes clearer, perhaps early in 2008. It is hoped that this example of joined-up regulation creates the conditions to allow FAIFs to flourish.

HEDGE FUNDS

15. Please give a brief overview of the hedge funds market in your jurisdiction. (How developed is the market? Has it been active in the past year?)

Although there are no domestic hedge funds domiciled in the UK, London is the second largest global centre for hedge fund managers, after New York, and is increasing its market share. According to figures from IFSL and EuroHedge:

- 80% of all European hedge fund investments at the end of 2006, totalling US$460 billion (about EUR318 billion), were managed out of the UK, the vast majority from London. This was an increase from 76% in mid-2005.

- London's share of the global hedge fund industry, by location of manager of hedge fund assets, more than doubled in the period 2002 to 2006 and increased from 19% to 21% between 2005 and 2006.

- All of Europe's top ten hedge fund managers ranked by assets are based in London.

16. What are the key statutes and regulations that govern hedge funds in your jurisdiction? What regulatory bodies are involved in regulating hedge funds?

UK-resident managers of offshore hedge funds are subject to the following key statutes and regulations:

- The Financial Services and Markets Act 2000 (FSMA).

- The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

- The Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001.

- FSA's Rules, in particular the rules in COBS.

17. How are the following areas regulated (if at all) in relation to hedge funds:

- **Risk.**
- **Valuation and pricing.**
- **Systems and controls.**
- **Insider dealing and market abuse.**
- **Transparency.**
- **Money laundering.**

- **Risk.** There is no regulation relating to the risk of investing in hedge funds, but the FSA does monitor industry developments.

- **Valuation and pricing.** There is no regulation, although the Alternative Investment Management Association (AIMA) has published a *Guide to Best Practice for Hedge Fund Administrators* that covers both valuation and pricing.

- **Systems and controls.** There is no regulation of the fund itself. The manager is subject to the provisions of SYSC in relation to, among other things, ensuring appropriate personnel are in place and that the fund is only marketed to those investors who are eligible to invest in it.

- **Insider dealing and market abuse.** The manager is subject to the provisions of the FSMA and FSA Rules dealing with market abuse, and to the Criminal Justice Act 1993 in relation to insider dealing.

- **Transparency.** The fund is a private entity, and accounts and records are not generally available. However, it is possible that the regulator in whose jurisdiction the hedge fund is located could request them.

- **Money laundering.** The manager is subject to the FSA Rules dealing with money laundering. In practice, money laundering checks for investors in hedge funds managed from the UK is undertaken by administrators outside the UK.

18. Who can market hedge funds?

Hedge funds can only be marketed in the following circumstances:

- By an authorised person, if the marketing is in accordance with the FSA's rules in COBS (this means, among other things, that the marketing cannot be made to the public generally, but only to a subset of the public (*see Question 19*)).
- By an unauthorised person, including an overseas person, if an exemption exists in the FPO.

19. To whom can hedge funds be marketed?

Hedge funds may be marketed to, among others, the following persons:

- High net-worth individuals and self-certified sophisticated investors (but only where the underlying assets of the fund are wholly or predominantly unlisted investments).
- High net-worth companies, partnerships and trusts.
- Sophisticated investors.
- Investment professionals.

If the marketing is done by an authorised person, hedge funds can also be marketed to the following additional categories, among others:

- Existing participants in a hedge fund.
- Existing customers, if the investment is suitable.
- Any professional client.
- Any retail client who:
  - is properly assessed by the authorised person to have sufficient experience to understand the risks involved;
  - has been given a clear written warning of the protections he may lose; and
  - provides the authorised person with a separate written acknowledgement that he is aware of the consequences of losing these protections.

20. Who holds the portfolio of assets? What regulations are in place for its protection?

The assets of most UK-managed hedge funds are held by prime brokers (large investment banks) based in London. CASS in the FSA Rules, which deals with matters including segregation and recording, applies to such firms.

21. Describe the key disclosure or filing requirements (if any) that must be done by the fund (for example, in relation to the prospectus or offering memorandum and side letters).

Disclosure and filing requirements depend on the location of the fund.

22. What are the key requirements that apply to managers/operators of hedge funds?

The manager of a hedge fund in the UK is subject to the relevant FSA Rules. This includes, in particular, SYSC and COBS (especially COBS 4 if the manager is involved in marketing the hedge fund in the UK).

23. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures? What are the participants' interests in the fund called (for example, share or unit)?

There are no hedge funds in the UK (*see Question 15*).

24. What are the advantages and disadvantages of using onshore and offshore structures?

There are no hedge funds in the UK (*see Question 15*).

25. Describe the tax treatment for:

- **Funds.**
- **Resident investors.**
- **Non-resident investors.**

- **Funds.** This depends on the location of the fund.
- **Resident investors.** UK resident investors in a hedge fund located outside the UK may be liable to pay UK income tax or corporation tax for any income distributions of the fund. Unless HM Revenue and Customs classifies the fund as a distributing fund, gains on disposing interests in the fund are taxed as income and not as capital gains.
- **Non-resident investors.** Not applicable (*see Question 15*).

26. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

Not applicable (*see Question 15*).

27. Please summarise any proposals for the reform of hedge fund regulation in your jurisdiction.

For the FSA's proposals for FAIFs, see *Question 14*.

In October 2007 the Hedge Fund Working Group (HFWG) published a consultation paper on hedge fund standards, focusing on five areas of concern: disclosure, valuation, risk management, fund governance and activism. Although the HFWG is not a regulator (its proposals appear designed to forestall increased regulation by the FSA), it seems likely, as its membership represents leading UK hedge fund managers, that once finalised its standards will be widely adopted by the industry. The HFWG plans to produce its final report early in 2008.