FSA and HM Treasury Pave the Way for UK Retail Funds of Hedge Funds

In a coordinated move, the Financial Services Authority ("FSA") and HM Treasury on 22 February 2008 made separate announcements regarding the introduction of a regime in the United Kingdom for retail-oriented funds of alternative investment funds ("FAIFs").

The FSA Announcement

Following on from its consultation of March 2007, the FSA has issued CP08/4, "Funds of Alternative Investment Funds". CP08/4 confirms FSA's earlier proposals to introduce FAIFs as part of the existing Non-UCITS Retail Schemes ("NURS"), in order to give retail investors greater investment options. In particular, under the proposals, UK authorised investment funds will be permitted to invest in funds engaged in long/short strategies, the traditional domain of hedge funds. CP08/4 also confirms that independent valuation of the underlying investments will not be required (a proposal that aroused some controversy, but which the FSA appears to believe was necessary for the market to operate successfully, given that most of the hedge fund market in the United States does not have independent valuation). Nevertheless, compared with the original proposals, the FSA's favoured approach – exercise of due diligence by the fund manager – has been strengthened by additional guidance.

CP08/4 also contains additional proposals on which consultation is sought, in particular on whether FAIFs should be allowed to be feeder funds. Given that the European Commission is proposing that UCITS should be able to act as feeder funds, FSA's unsurprising argument is that they should, subject to safeguards. The safeguards include making the manager of the feeder fund responsible for any failure of the master fund to act in a way consistent with the investment powers and borrowing limits rules applying to NURS.

The FSA's consultation closes on 22 May 2008, with the FSA aiming to make the final adjustments to the regime before the end of 2008. This suggests that FAIFs will not come into being until the beginning of 2009 at the earliest, which is a disappointedly protracted timetable, given that the original proposals were published nearly a year ago.

The HM Treasury Announcement

The FSA had indicated in its original March 2007 consultation on FAIFs that there were a number of difficult tax issues involved with an onshore FAIFs regime, and that they were discussing these with HM Treasury. HM Treasury has now announced a tax framework for FAIFs designed to remove the major tax obstacles, and on which comments are invited.

Broadly, under existing UK tax law, a 20% corporation tax charge applies to income realised by UK authorised investment funds – open ended investment companies ("OEICs") and authorised unit trusts ("AUTs"); conversely, capital gains made by these funds are tax exempt. Further, gains realised by UK investors, including authorised investment funds, on the sale or redemption of interests in non-distributing offshore funds are taxed under the 'offshore funds rules' as income, rather than capital gains. The overwhelming majority of hedge funds are non-distributing, with proceeds from their trades being reinvested. Consequently, if this tax treatment were allowed to continue, UK authorised investment funds would be subject to a 20% tax charge on any gains arising from a sale or redemption of interests in a non-distributing hedge fund, which would severely restrict the development of FAIFs.

HM Treasury intends to introduce draft legislation in Spring 2008 which will allow UK authorised investment funds set up as OEICs or AUTs to elect to receive disposal proceeds from investments in non-distributing offshore funds without a charge to corporation tax. HM Treasury envisages that, instead, investors in FAIFs will be treated as if they had invested in the underlying non-distributing offshore fund directly. This is consistent with HM Treasury's aim, so far as possible, of aligning the tax treatment of investors in FAIFs with direct investments in offshore funds by such investors. Such investors will accordingly be charged to income tax, or corporation tax on income in the case of corporate investors, on the eventual disposal of their respective holdings in the FAIF - thereby effectively applying the offshore funds regime to their holding in the FAIF. Investors who are currently exempt from tax in respect of their holdings in FAIFs will continue to be exempt. Further, there will be no minimum holding requirements for non-distribution offshore fund assets. The announcement by HM Treasury contains little further technical detail on how the new tax regime is intended to operate; this will hopefully be clearer when the draft legislation is published.

Further, while the initial regime is only expected to be suitable for FAIFs that are investing in non-distributing offshore funds, HM Treasury is still consulting on whether the new regime can be amended over time so as to be taken up by FAIFs that are invested in a mix of non-distributing offshore funds and other investment assets, including distributing funds. This question may be particularly topical given that the introduction of the new 18% capital gains tax rate with effect from 6 April 2008, and the consequential disparity between capital gains and income tax rates, are expected to lead to an increased number of distributing offshore funds being launched. Separately, HM Treasury is currently consulting on the offshore funds regime itself.

Overall, the FSA and HM Treasury announcements are, however, clearly good news for the retail fund and hedge fund industries, combining a new tax regime that will enable the launch of UK fund of hedge funds with a broadening of the investor base which can access offshore hedge funds.

Detailed rules are expected to follow, and Kaye Scholer will continue to provide updates.

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