

Financial Services

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FAIFs at last

Following a protracted consultation period which started in 2007 but lost impetus as a result of the Madoff scandal and the FSA's attention on the financial crisis, the FSA has published its long awaited rules allowing for the establishment of funds of alternative investment funds (**FAIFs**). The FSA has chosen to incorporate the FAIF rules in a new section of Chapter 5 of the Collective Investment Schemes Sourcebook (COLL 5.7), as it concluded that to incorporate them into the current COLL 5.6 (the investment and borrowing powers as they apply to conventional NURs) was too confusing.

The FAIF rules came into effect on 6 March 2010.

What can a FAIF do?

Invest up to 100% in unregulated collective investment schemes

A FAIF is a type of non-UCITS retail scheme (**NURS**) which has greater flexibility to invest in a range of unregulated collective investment schemes, including hedge funds. This greater flexibility means that a FAIF could, potentially, invest up to 100% in unregulated schemes, subject to those schemes meeting certain requirements set out in the new COLL 5.7. A FAIF can also invest in the other classes of assets available for NURs, meaning that a FAIF does not have to be a pure fund of funds scheme investing in range of collective investment schemes but could be a hybrid scheme investing in a diverse range of assets.

The FSA have also slightly modified the aggregation rules where a FAIF is to invest in unapproved securities and unregulated schemes. Under the rules as they apply to a conventional NURS, where that NURS invests in unregulated schemes, it may only have an aggregate 20% exposure to unapproved securities and unregulated schemes. No such aggregation applies for FAIFs.

Master/Feeder Structures

Also permitted are master/feeder structures under which a FAIF is permitted to feed into

a master scheme (which may be based in the UK or abroad) which in turn invests in a wider range of underlying schemes. Where a master/feeder structure is used, the manager of the FAIF feeder is responsible for ensuring that the master scheme is operated in accordance with the investment powers and borrowing limits for FAIFs although the FSA's previous approach of applying the NURS rules on investment powers has been dropped.

Due Diligence

FAIF managers are subject to detailed initial and ongoing due diligence obligations in respect of underlying schemes in which they propose to invest. The due diligence requirements are set out in detailed guidance in COLL 5.7 and while the FSA has retained the more detailed elements of its previously suggested due diligence requirements, it has also strengthened its requirements in respect of custody and valuation. As a result if an investment in an underlying scheme is to be made, FAIF managers must satisfy themselves that underlying funds have their property held by an independent third party and that calculation of net asset values and maintenance of accounting records are segregated from the investment management function.

The FSA's view is that although FAIFs have wider investment powers, they are still retail schemes which can be sold to the general public with little or no advice. The FSA considers that these investors will rely on the investment manager to know and understand the risks associated with the investments which the FAIF will make. The FSA has concluded that if an investment manager cannot obtain enough information on a target investment to satisfy the FSA's due diligence requirements, the FAIF should not invest in it.

Payment of Redemption Proceeds

As FAIFs are likely to be invested in relatively illiquid assets, the rules on limited and deferred redemptions have been modified from those published at the consultation

stage in 2008, to give FAIFs greater flexibility in the time allowed to calculate NAV and to pay redemption proceeds. The current rules require managers to pay investors the proceeds of redemption within a period of T+4. FAIF managers can, however, take up to 185 days before paying redemptions. Also, FAIF structures are now included in the qualifying criteria for limited redemption and are excluded from the requirement for higher volatility funds to have at least one valuation point every business day.

Details of how units are redeemed must be disclosed in the FAIF's scheme documentation in order that investors fully understand the redemption arrangements and the maximum period between the request to redeem units and payment of redemption proceeds.

Taxation

A previous concern as to the take-up and effectiveness of FAIFs was the taxation regime as it applied to offshore funds which could lead to offshore income gains being taxable at both fund and investor level. However this has been addressed by a new tax regime for funds which invest in non-distributing offshore funds - the broad effect of which is, subject to certain qualifying criteria, to move the point of tax in respect of offshore income gains from the fund to its investors who will be taxed on any gain arising on their investment in the FAIF as if that gain were income.

As a consequence of the introduction of this new tax legislation, the FSA has agreed with HM Treasury and HM Revenue and Customs that the genuine diversity of ownership requirements concerning FAIFs are no longer needed in COLL but instead are to be found in The Authorised Investment Funds (Tax) Regulations 2006 (as amended). This reflects the approach taken in relation to TEFs and PAIFs.

Authorisation process

The FSA's intention is that the FAIFs authorisation process is an extension of the current NURS process. The FSA has stated that it will ask managers to provide additional information focusing on due diligence procedures, processes, resources in place and the suitability of their processes with the depositary.

For those wanting to set up a FAIF, it is our view that there would be merit in having an early discussion with the FSA to flush out any particular issues and to enable you to get as good a handle on any other types of issues that the FSA would want to consider during their review of the application, in addition to those noted above, as soon possible.

This Bulletin is correct to the best of our knowledge and belief at the time of going to press. It is however written as a general guide, so it is recommended that specific professional advice is sought before any action is taken. We are required by law to protect personal data.

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