

27<sup>th</sup> June 2007

Sally Rigg  
Mortgages, General Insurance and Collective Investment Schemes  
Retail Policy Division  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

Dear Sally,

**DATA Response to CP07/6 - Funds of Alternative Investment Funds (FAIFs)**

The Depository and Trustee Association (DATA) represents all depositaries and trustees of UK-based authorised unit trusts and open-ended investment companies (OEICs), and are responsible for safeguarding approximately £395.9 billion of funds under management. The member firms are:

- ABN AMRO Mellon Global Securities Services B.V.
- Bank of New York Trust and Depository Company Limited
- Brown Brothers Harriman Investor Services Limited
- Citicorp Trustee Company Limited
- HSBC Bank Plc
- J.P. Morgan Trustee and Depository Company Limited
- The Royal Bank of Scotland Plc
- State Street Trustees Limited

DATA welcomes the proposed inclusion of funds of alternative investment funds (FAIFs) in the existing NURS regime. It will provide a number of opportunities for UK managers and UK investors that are available in other jurisdictions. It is right that appropriate safeguards are being suggested to ensure that investors understand the nature of FAIFs and their associated risks.

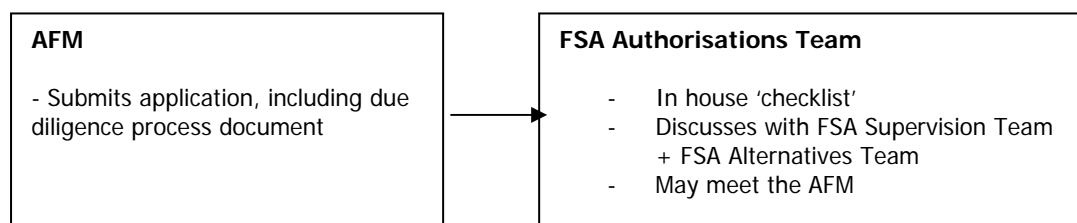
We note that many authorised fund managers (AFMs) have expressed reluctance to consider too seriously the types of funds they might launch until the tax situation for FAIFs is resolved, worrying that this could result in another 'QIS' situation whereby rules are introduced but nobody can make use of them because tax issues have not been resolved. It is absolutely critical that the fund of offshore funds tax regime is amended to ensure that the FAIF is not at a disadvantage as a result of its tax treatment. FAIFs need to be competitive with offshore funds of hedge funds, and one way of putting them on a par with offshore funds for tax purposes would be to exempt them from tax on gains on their investments, but to apply income tax treatment to the investor in the FAIF when disposing of their interest in the FAIF. This would give a FAIF parity of tax treatment with an offshore fund of hedge funds. We

understand that HMRC are looking at FAIFs as part of the OSF regime and will be consulting on this in the next few months.

The attached response focuses largely on fund of hedge funds (FOHFs), as these are the types of FAIF that have been debated publicly. However the proposals provide considerable opportunities for funds of property vehicles, private equity or institutional vehicles which should not be overlooked. For these tax will not generally be an issue.

There are issues that are specific to FAIFs, and in particular to FOHFs, as discussed in the recent IOSCO Consultation Report "*Call for views on issues that could be addressed by IOSCO on fund of hedge funds*". The FSA will need to apply additional attention to FOHFs in respect of the complexity of the risks, the investment strategies and the valuation of the assets, which demand special skills. It is key that only AFMs with the relevant expertise are approved to operate a FAIF and vital that the FSA apply a suitably robust authorisation procedure for the fund.

We note that CP07/6 does not make any comment on how the FSA will be authorising such funds and we suggest the FSA authorisation process could potentially be structured as follows:



*"Interactive process"*

Some AFMs whilst welcoming the FSA's commitment to product development and product innovation, have advised that they are also nervous, commenting on the potential reputational risk for the UK retail market should a UK FAIF, particularly a FOHF, collapse. We do not believe that AFMs will be rushing to launch these products, not just because of the tax situation (as previously explained) but also because firms are looking for reassurance from the FSA that it will apply an appropriate authorisation process and only firms with the relevant levels of expertise will be authorised to launch FAIFs. In the CP Annex, clause 5.6.10B, the FSA outlines the proposed due diligence for the purpose of the second scheme's manager, but it is important that the FSA itself applies adequate due diligence at the level of the AFM itself.

Retail investors are used to daily dealing, open-ended funds, with a high level of liquidity and, importantly, being able to process redemptions over a short and familiar time frame. We note that CP07/6 does not comment on the level of disclosure required in the offering documentation. It is vital to the success of the products and our industry's integrity that we treat customers fairly and investors understand what they are buying and the associated risks. FAIFs are open-ended vehicles, so it is important that investors can take their money within a reasonable time frame and that AFMs are able to manage the liquidity of these products in an efficient manner.

We predict a divergence in the types of FAIFs. We believe that there will be AFMs who launch a 'conservative' type of FAIF, which keeps closer to the existing NURS regime e.g. retains independent valuation, prohibits side pockets. There will also be those AFMs who wish to use maximum flexibility and push the boundaries as far as the regulations will permit.

Alternative investment products are already available in other jurisdictions and we support the FSA's approach to making such funds available within an authorised collective investment

scheme with its associated investor protections. At the same time, these are retail products, so a level of caution needs to be applied.

In terms of our role as depositary, we see no change from the existing requirements of COLL 6.6.4R(1). However, we note that there will be additional complexities for the depositary to consider as part of its oversight responsibilities.

To conclude, we reiterate the importance of disclosure to investors. It is imperative that investors understand what they are buying and the associated risks, with prominent and clear disclosure in the offering documentation.

Please find attached our responses to the specific questions raised. We look forward to discussing these further with you.

John Cargill  
Chairman of DATA

**Q1: What types of product do you believe are likely to be developed as FAIFs, making use of the wider investment ability into unregulated schemes?**

AFMs are considering FOHFs and to a lesser degree property funds and private equity. In addition, life assurance products will potentially benefit assuming that FAIFs will be included as a permitted link. There has been much public debate about FOHFs, and the problems with the tax regime are known. Therefore, discussions have continued to focus on FOHFs. However, the FSA's proposals would provide considerable opportunities for funds invested in property, private equity or institutional securities vehicles, and this should not be overlooked.

**Q2: To what extent is it likely that the FAIF proposals would be used to create "hybrid" schemes where unregulated schemes are held along with other NURS eligible assets, as opposed to pure fund of funds? What types of "hybrid" scheme do you foresee being produced?**

We predict that "hybrids" will be produced and we support greater investment flexibility. We envisage that the additional investment powers will be particularly advantageous to managers who have "multi-asset" schemes, absolute return and lifestyle products which benefit from the flexibility to invest in a broad range of asset classes.

Although we expect the majority of FAIFs to be launched as new vehicles, some AFMs may wish to 'convert' their NURS to a FAIF and hold above 20% in unregulated schemes. The AFM will need to discuss this with their depositary and such a change will trigger a change event. From an investor protection perspective, our preference would be a "hybrid" to be launched as a new fund, as increasing significantly the NURS exposure to unregulated schemes will significantly change the risk profile of the fund and how the fund operates. We believe therefore that a NURS moving to a "hybrid" structure should be considered on a case by case basis. We also note that the FSA's statutory approval process of only one month (applicable to a 'conversion' as opposed to up to the six month authorisation period for a new fund) may require additional flexibility.

**Q3: Are there any other matters not covered in the due diligence guidance on which guidance is needed? Please specify?**

In step with the FSA's principles based approach, the due diligence criteria are set at a high level.

Some firms are happy with the high level approach, some were less so. For firms that have the expertise, for example firms who have in-house experience with hedge funds, our feedback is that the high level approach is sufficient. For those firms that do not have the expertise in house, feedback is that more guidance will be required from the FSA. It is important that the FSA authorisation process takes a view on which firms do and do not have the relevant expertise.

DATA recommends that due diligence should be documented by the AFM. This would aid the process of launching the fund and help the depositary perform its oversight function. In addition it would assist the authorisation process with the FSA – both in terms of demonstrating that the AFM has the necessary expertise and assisting the FSA in determining whether the firm has the capability to launch and manage a FAIF with its additional complexities.

Although we see no change in the role of the depositary, we note that there will be additional complexities for the depositary to consider as part of its oversight responsibilities.

In the CP, paragraph 3.6, the FSA sets out the matters they believe that 'a FAIF manager should take into account in making substantial investments into one or more unregulated schemes'. However the due diligence outlined under 5.6.10B only relates to second scheme's manager. There are no specific rules for the FAIF manager itself.

Under clause 5.6.10B (7), we recommend that the sentence be amended as follows 'the level of liquidity offered by the second scheme and whether it is sufficient for the investing scheme to be able to meet its obligation to redeem the units as stated in the scheme documentation'.

Clause 5.6.10R (3) could be more clearly worded as follows 'the non-UCITS retail scheme's authorised fund manager is satisfied, on reasonable grounds, that the second scheme will not invest more than 15% in the value of the property of that scheme in units of other collective investment schemes'. The same comment would apply to COLL 8.4.5R (2) (d) regarding the QIS.

**Q4: What is your view about our proposal to approach the valuation question in the way suggested, bearing in mind the need to ensure that the prices of the FAIF must be accurately calculated?**

Independent valuation provides reassurance to its investors that the methodology and calculation of a price is accurate. Removing this criterion is a significant issue, in particular for retail investors and thus should be clearly disclosed in the offering document.

We accept that applying the independent valuation criteria to FAIFs would limit the AFM's access to many hedge funds, in particular in the US market. We also accept that where AFMs choose to invest in funds that do not apply independent valuation, that the combination of due diligence criteria plus the IOSCO's 9 principles of valuation should be applied (*please note that these are under consultation*).

We believe that some AFMs will be more cautious and will invest only in those funds that do have independent valuation.

For AFMs who wish to invest in funds without independent valuation, they will need to allocate time and money to applying the levels of research to consider (a) underlying schemes' pricing and valuation methodology and level of liquidity and (b) underlying schemes' governance arrangements and expertise and experience of their managers. We believe this will create additional work for AFMs and we recommend further consideration be given as to how practically this will be done. How the FSA authorisation process considers the AFM's handling of this issue is vital.

The FSA rules are silent on the treatment of estimated versus real prices and it is our understanding that there are a variety of approaches adopted by managers of FOHFs. It is therefore important that the AFMs pricing policy is detailed in its due diligence procedures and clearly disclosed in the offering documentation.

**Q5: What is your view on the appropriateness and workability for FAIFs of a six month limited redemption provision?**

Our feedback overall from the industry is that a six-month limited redemption provision is appropriate and workable.

**Q6: Is a notice period required for FAIFs in addition to the existing limited redemption provision? If there were no notice periods allowed, would FAIFs be likely to invoke deferred redemption provisions? If so, what is your estimate for the frequency of doing so?**

We recommend that notice periods be permitted. Many of the underlying hedge funds have notice periods so the closer the FAIF can mirror the redemption arrangements of its underlying investments the better. AFMs who have experience managing FOHFs have advised us that notice periods are necessary to allow the AFM to effectively manage the portfolio of the FAIF and its redemption process.

**Q7: Do you agree that the normal NURS redemption payment standards should be applied to FAIFs? If not, please give reasons.**

Since the FAIF will be a retail product, we believe that where possible the ideal is to keep to the current NURS redemption payment of four days. However, in respect of FOHFs, feedback from members with hedge fund experience is that it will be impossible to meet T+4 settlement in view of the complex underlying hedge funds and factoring in the time necessary to obtain the hedge fund prices.

We recommend further consideration be given to this issue.

**Q8: What are your views on our proposed approach to side pockets?**

According to the Deutsche Bank Alternative Investment Survey 2006, in 2006 there was a growth in the number of hedge funds with side pockets. However, it is our understanding that funds with side pockets are still in the minority.

We accept the FSA's proposal that side pockets should be treated as part of the due diligence process. However, with the level of additional complexity already facing the AFMs to ensure the FAIF has sufficient liquidity to meet foreseeable redemption requests from its investors, we would consider investment in funds with exposure to side pockets as an exception to the norm and our preference would be to avoid them, at least in the short-term. DATA recommends that if side pockets are used, that the AFM should set an in-house limit which should be discussed with the depositary. If the AFM wishes to use side pockets, this needs to be clearly disclosed in the prospectus, together with the appropriate risk warnings.

**Q9: What are your views on our proposed change to the "15% rule" making it a matter for the NURS scheme's manager to determine whether any scheme in which he might invest might in turn invest more than 15% of its assets in other collective investment schemes?**

Overall we agree with the FSA's option 2, though we would ask for 'reasonably satisfied' to be clarified. Would side letters need to be obtained (which may not be possible in all circumstances) or would regular monitoring suffice?

**Q10: What are your views on the proposed exception from the "15% rule" for feeder funds, permitting a NURS to invest in an unregulated scheme that is itself dedicated to investing all of its assets into one "master" scheme.**

We support this proposal.

**Q11: What are your views about the appropriateness of allowing NURSs to act as feeder funds? Can sufficient controls be put in place in the interests of the consumer protection, particularly where the master fund might itself be domiciled offshore?**

We acknowledge the issue of feeder funds is being considered as part of the European Commissions Exposure Draft but we believe this is a different issue as potentially (and more likely) the FAIF would be a feeder investing into a master domiciled outside Europe. However, we feel it is too early to consider this proposal as part of the FAIF's consultation.

**Q12: Should the 35% limit for FAIFs (as applies to other NURS) remain the same, be increased or reduced?**

We received a mixed response from AFMs who advised that this was depended on the strategy of the FAIF. The FAIF needs to be managed to allow sufficient liquidity to meet foreseeable redemption requests (e.g. an objective of the due diligence criteria) so we would expect more than 3 holdings in a FAIF to ensure prudent spread of risk. We recommend therefore that the limit for FAIFs remains the same.

**Q13: What are your views on the proposal that FAIFs should be subject to the same borrowing limit as other NURS?**

In view of the fact that the underlying funds held by the FAIF may be leveraged/geared, we agree that the FAIF itself should be subject to the same borrowing limit as other NURS.

Please note that in paragraph 3.35 of the CP, the statement that 'In addition, any borrowing must be on a temporary and non-persistent basis' is not applicable to a NURS. Instead, COLL 5.6.2 G (2) (f) is applicable, whereby the NURS is able to 'borrow on a non-temporary basis without any specific time limit as to repayment of the borrowing'.

**Q14: What are your views on the proposal to continue the existing aggregation of unregulated schemes with the 20% limit for unapproved securities?**

The current proposal would result in a FAIF which invested more than 20% in unregulated schemes being prohibited from investing in unapproved securities. We disagree with this approach and suggest that unapproved securities should have a separate limit. Not altering this proposal will cause a problem for property funds, namely COLL 5.6.19 R (6) (c), *which currently permits any transferable securities which are not approved securities* to be held as part of the scheme property of a scheme.

**Q15: Are there any other NURS rules, which we have not identified, that should be changed to accommodate the development of FAIFs? If so, please give full reasons as to why and how the rule would require amendment.**

Can the FSA clarify that FAIFS which are part of the NURS regime, will automatically be a permitted link for life assurance products?

Can the FSA confirm whether it is possible for a FAIF to be launched as a sub-fund of a NURS umbrella fund?

Does the FSA intend to issue guidance on fee disclosure for FAIFs, in particular performance fees for the underlying funds?

**Q16: (a) What is your view on the draft rules included in Annex 4?**

**(b) What is your view about the due diligence approach in regulating the nature of the underlying investments of a FAIF? What are your views on the due diligence guidance provide?**

- (a) We agree that amending the existing NURS rules is the appropriate way to approach FAIFs.
- (b) We note that investments above 20% in unregulated schemes will trigger due diligence guidance. We would like the FSA to clarify: (i) if an existing NURS becomes a FAIF, whether due diligence criteria will apply to all the unregulated holdings as opposed to only the holdings above 20% and (ii) if a NURS' holdings goes above 20% due to market movements, whether this will be treated as an inadvertent breach?

**Q17: What are your views on the Case Study?**

No comment.

**Q18: Do you agree that the due diligence requirements will not impose additional compliance costs of more than minimal significance?**

Managing a FAIF will create additional compliance costs in view of the complexity of the product. From our discussions with the industry, AFMs accept this as a requirement for entering the FAIFs arena.