

Authorised investment funds technical release

March 2010

In this authorised investment funds technical release we summarise two recent regulatory developments in relation to COLL which came into effect on 6 March 2010. These include amendments to the accounting and distribution provisions, and the publication of new rules introducing funds of alternative investment funds as part of the FSA's non-UCITS retail regime.

COLL accounting amendments

The FSA has published the various accounting rule changes to COLL consulted on in July 2009. The final version of the rules is substantially similar to those consulted on.

In summary, the main rule changes are:

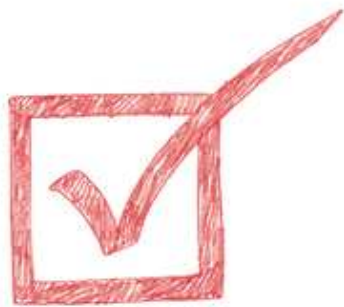
1. Re-introduction of the requirement for ACDs/managers to approve/sign annual and half yearly reports (COLL 4.5.8B). This is likely to have little noticeable impact as it is something which most already do in practice.
2. Amendment to COLL 6.7.10, which states that transfers of income shortfalls to capital at the end of an annual accounting period are share class specific. This clarifies that one share class can (and should) pay a distribution when other share classes have a deficit of income, which could be a change in practice for some funds.
3. In the ACD's/manager's report, as well as disclosing the investment objectives and policy, there is a requirement to include a description of the strategy which the manager follows to achieve the objectives (COLL 4.5.9(6)). Some funds cover this already but a number of funds may have to say more in future. This also affects the short report.
4. The rules on accounting periods are relaxed to allow the manager to end the annual or half yearly accounting period up to 7 days before or after the normal date (COLL 6.8.2(6A)). Incidentally if funds decide to flex their accounting period under this rule please note that there may be implications for the fund's tax returns.
5. The portfolio statement (which was previously in the accounts) is now part of the ACD's/manager's report (COLL 4.5.9(7A)) - this is consistent with the 2008 SORP.
6. A new rule is introduced clarifying that an accounting period can end either at close of business or at the last valuation point on the final day of the period (COLL 6.8.2(5A)) - again this is consistent with the SORP.
7. The definition of income property is amended to more closely align with the 2008 SORP and the amount available for income allocations is set out in greater detail. The amount available for allocation/distribution (COLL 6.8.3(3A)) is the net revenue after tax in accordance with the SORP after making any adjustments which may be required/permitted for:
 - coupon based distribution policy for debt securities
 - treatment of indexation in index linked bond ('ILB') funds (NB this applies to index linked gilts only and only to funds that invest predominantly in ILBs ie. ILB funds. Any waivers granted by the FSA in respect of ILB funds remain in force but will not be renewed)
 - stock dividends (which funds can elect to treat as income or capital for distribution purposes)
 - equalisation received as part of distributions from other collectives (NB this is now accounted for as capital under the 2008 SORP but the fund may still (optionally) have a policy to distribute it)
 - allocation of expenses to capital (eg ACD's/managers' fees and other expenses)
 - taxation (for example from applying the marginal method set out in the SORP)
 - equalisation on creations /cancellations.

None of these provisions on income allocation introduce anything fundamentally new, with the notable exception of the reference to indexation adjustments in index linked bond funds. But the revised rule brings together in one place the various potential distribution adjustments and promotes consistency with the SORP.

The implementation arrangements for these amendments to COLL are that:

1. The changes came into effect on 6 March 2010.
2. For a report for an accounting period ending before 6 March 2010 - the existing COLL rules can be applied, but this requires the AFM, depository and auditor to elect for this together and the AFM is required to make a record of this election.
3. For reports for accounting periods ending after 6 March 2010 - the COLL amendments apply.

In practice this means that the COLL revisions are compulsory for 6 March 2010 year ends onwards. The main potential reason for not adopting the new provisions for December, January or February year ends might be if there are difficulties with COLL 6.7.10. Otherwise it may be relatively straightforward for many funds simply to comply with the new rules for fund reports finalised after 6 March - subject to ensuring that these reports deal with the need for disclosure of the strategy pursued for achieving the investment objectives. For any pre 31 December 2009 year ends which are not finalised before 6 March 2010 and where the reports are still being prepared under the old 2005 SORP it is likely to be necessary to take advantage of the transitional rules in order to avoid any conflict between COLL and the SORP.



Funds of Alternative Investment Funds ("FAIFs")

The FSA has now published its final COLL rules for FAIFs. In conjunction with this, HMRC have published related amendments to the tax rules relevant for authorised funds which invest in non-reporting offshore funds. Both these new provisions came into effect on 6 March 2010.

Key features of the regime include:

1. A FAIF can invest up to 100% of its assets into unregulated collective investment schemes including, for example, hedge funds based in non-EU countries.
2. A FAIF is a Non-UCITS retail scheme ("NURS") which can be sold to retail investors - as such, borrowing by the fund is restricted to 10%. If leveraging were to be used the manager could set up a QIS fund as an alternative although QIS funds could not be sold to retail investors.
3. A FAIF's manager must carry out due diligence on the underlying schemes in which it invests. There is guidance in COLL as to what this involves but it will mean, inter alia, ensuring that the underlying scheme:
 - is audited
 - is compliant with legal and regulatory requirements
 - has independent custody arrangements for its assets
 - has adequate valuation procedures
 - has NAV calculations and accounting records which are segregated from the investment management function
 - has liquidity policies and dealing arrangements sufficient to enable the FAIF to meet its redemption obligations
 - has adequate systems and controls and risk management processes
4. A FAIF can operate as a feeder scheme investing into a master fund (which can be in the UK or abroad) but if it does so, the manager must ensure that the master fund complies with the rules as if it were a FAIF.
5. A FAIF has special rules on redemptions giving greater flexibility in the time allowed to calculate NAVs and pay away redemption proceeds. Basically the rules give the manager up to 185 days to effect redemption, reflecting the illiquid nature of the underlying assets and the infrequency of dealing in the underlying funds.

6. The tax changes deal with the situation where an authorised fund invests in a non-reporting offshore fund - such funds are referred to as FINROFs. Features of the tax regime for FINROFs include:

(i) it applies automatically to AIFs that invest more than 20% of the value of their assets in non-reporting offshore funds;

(ii) the point of tax is moved from the AIF to the investor. The investor will pay tax as if he or she had invested directly in the non-reporting offshore fund - this effectively means that the investor will pay tax on the entire gain arising from disposal of a FAIF as income. The FAIF itself will be exempt from tax on gains arising from holdings in non-reporting funds;

(iii) any AIF can elect into the regime, even if it holds less than the 20% automatic threshold for inclusion. Such election may be potentially attractive for funds with non-taxpaying investors. It should be noted however that for AIFs which do not invest all their assets in non-reporting offshore funds the regime could result in investors being worse off, unless they are all exempt and therefore the tax rules as they stand have relatively narrow application.

As regards the tax position of FAIFs, the situation may be complicated by the fact that a number of hedge funds are now applying for reporting fund status. Where FAIF portfolios include a mixture of reporting and non-reporting funds, tax inefficiencies could become a consideration to the extent that investors in the FAIF are not tax exempt.

There is also some uncertainty over the potential impact of the Alternative Investment Fund Managers Directive on the FAIF regime - both in terms of the effect it might have on the UK's NURS regime and how the third country aspects might affect EU investor choice. The final draft of the Directive has yet to be agreed although this is still scheduled to happen before the second half of this year. It remains to be seen therefore how well FAIFs might compete alongside the UCITS-compliant hedge fund style products which have been growing in popularity, particularly in the past 12 months.

The new rules and associated tax regulations are however a welcome conclusion to the deliberations on FAIFs which have been ongoing for a number of years.

Contact us

If you would like to discuss any of the matters raised in this release further, please contact Alastair Robertson or Anne Stopford on the details below.



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