Hedge Funds and the UK
A cross border dialogue on current issues and recent developments

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Distributor Funds
For UK Tax Purposes

Danny Asher Brower
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K&L Gates, London

- Hedge funds
- Retail funds (e.g. European UCITS)
- Private equity funds
- UK regulatory advice (e.g. UK Financial Services Authority and compliance advice)
- Full service London office (corporate, litigation, enforcement, real estate, banking, securitisation, pensions and employment departments)
Distributor Funds - Introduction

- Old regime
- Consequences of the old regime
- New regime
- Consequences of the new regime
Old UK Regime
UK Regime – Offshore Funds

- Gains from disposals of interests in offshore funds taxed on an income tax basis for UK individual tax payers
- Income tax is 40% for UK tax payers on earnings greater than £36,000 ($72,000) per annum
Old UK Regime - What is a Distributor Fund?

- A distributor fund must be certified as a “distributor fund” by Her Majesty’s Revenue & Customs in the UK.
- A distributing fund must distribute 85% of its “income”
Old UK Regime – What is Income?

- “Income” includes dividends and interest from the fund’s investments
- “Income” does not include gains made on long term investments (i.e. interests held in order to receive interest/dividends)
- “Income” does include trading profits from sale of short term investments (i.e. investments bought and sold for gain alone)
Old UK Regime

- UK individuals will pay income tax on the 85% of distributed “income”
- Distributor funds may only invest 5% of their assets in other offshore funds (funds of funds will not gain distributor status)
Old Regime – Distributor Funds

- Disposal of material interests in distributor funds by individual UK taxpayers subjected to CGT
- CGT was 40% with personal allowance of £9,200 ($18,400) before CGT was charged
- Distributor status of benefit to UK taxpaying individuals only and not to companies
Consequences of the Old Regime

- Relatively few hedge funds have sought UK distributor status as tax advantages for the UK taxpayers were not that significant and hedge funds generally prefer to roll up and not distribute gains.
The Government’s Proposed Changes in the 2008 UK Treasury Budget
New Regime – Reporting Status

- 2008 Budget confirmed that legislation would be drafted to allow an offshore fund to “qualify” for distributor status if it either “reports” 85% of its income to its UK investors or physically distributes 85% of income to UK investors
- UK investors will have to pay income tax on the 85% of “income” reported or distributed
New Regime – Change in Rate of CGT

- 2008 UK Treasury Budget cut CGT from 40% to 18%
- Real incentive for hedge funds to achieve distributor status
- Increase in demand from UK investors
- Personal CGT allowance also increased to £9,600 ($19,200)
New Regime – Reporting Status

- Conditions for obtaining distributor status will be less onerous
Consequences of the New Regime

- “Qualifying” for distributor status is easier for offshore funds as distributor funds can either physically distribute or merely report income
- UK investors will have to pay income tax on the amount reported or distributed
Consequences of the New Regime

- It is likely that more hedge funds targeting UK investment will seek distributor status because of the 40% to 18% reduction in CGT.
- Legislation will be drafted in the Finance Bill 2008 to include the new regime proposed by the 2008 UK Treasury Budget.
Distributor Funds – Flying the Flag for Britain?
Hedge Funds and the FSA

Neil Nick Robson
K&L Gates, London
Hedge funds regulation in the UK

- FSA only has jurisdiction over activities with a UK nexus.
- Funds generally established in Cayman Islands for tax reasons, but UK is major global centre for hedge fund managers.
- FSA usually regulates the manager rather than the fund.
FSA regulation of hedge fund managers

- UK-based fund managers regulated under FSA Rules
- Rules based on EU directives designed to harmonise financial service laws across the EU member states.
FSA approach to regulation

- FSA approach is risk based
- 35 larger hedge fund managers deemed more “risky” - subject to closer scrutiny
- Specialist FSA team to supervise the 35 “risky” funds
- FSA gathers information from regulatory filings and also from transaction reports from counterparties - UK banks and investment brokers.
Hedge funds and the sub-prime crisis

- Statement by Dan Waters, FSA sector leader, in April on the current market turmoil
- FSA view that hedge funds are not the catalysts or drivers of the present situation
- FSA reiterated that hedge funds have an important role in increasing market efficiency and providing benefits.
FSA Supervision

Robert Hadley
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FSA Supervision

- FSA assesses firms’ risk profile
- ARROW 2
  Risk = Impact x Likelihood
- Small Firms
- Full ARROW assessment
- “ARROW Light”
FSA Supervision

- FSA Principles for Business Principle 11
- Authorised firm must “deal with its regulators in an open and co-operative way and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice”
- “Open and Co-operative” FSA Handbook SUP 2.3.3
FSA Supervision

- ARROW Visits
  - Pre-Visit Information Request
  - Draft Report
  - ARROW Letter

- Thematic Visits – “Sweep”
  - No presumption but in practice a clear risk of Enforcement action – by definition the issue is an FSA priority

- Other Supervisory Visits
  - Can be without notice
FSA investigating market abuse

- Recent series of unfounded rumours about UK financial institutions
- US$6 billion wiped off HBOS share value in a single day of trading
- FSA currently investigating short-selling trades for possible market abuse
Hedge fund investment valuations

- FSA have called for harmonised standards in valuing hedge fund investments
- UK examples - AIMA standards and Hedge Fund Working Group (HFWG)
Hedge fund working group - standards

- HFWG = representatives of 14 principally UK-based hedge fund managers
Hedge Fund Standards Board (HFSB)

- HFSB set up as ‘custodian’ of standards by HFWG
- Trustees of the HFSB responsible for future updates and encouraging convergence with US initiative (President’s Working Group)
- Voluntary standards run on a ‘comply or explain’ basis
- Managers to confirm compliance annually.
HFWG – 5 ‘areas of concern’

- **Disclosure** – proposed increase; appropriate mechanism for changing investment policy
- **Valuation** – using a robust and transparent methodology
- **Risk management** – managers should use a comprehensive approach emphasising liquidity
- **Fund governance** – fund board to have suitable experience & appropriate level of independence
- **Activism** – disclosure of interests in companies e.g. through disclosure of CfDs.
HFWG – UK-US issues

- MFA – agrees in principle with most of the standards, however:
  - Fund governing bodies may not be independent
  - Third party administrators should not be mandatory
  - Many US hedge funds have non-independent in-house personnel for valuing hard-to-value assets
  - Hedge fund managers should not be required to maintain a website.
New FSA rules on telephone recording

- FSA to introduce taping rules in March 2009 to help prevent, detect and deter market abuse
- Firms required to take reasonable steps to record and retain communications which involve:
  - receiving client orders; and
  - negotiating, agreeing and arranging transactions;
  - across bond, equity, financial commodity and derivative markets.
- Communications include both telephone conversations and electronic communications.
New FSA rules on telephone recording

- Rules apply only to activities carried on from an establishment within the UK
- Retention period of 6 months reduced from original proposal of 3 years
- The following are excluded from the taping rules:
  - mobile phone conversations (will be reconsidered in 18 months);
  - corporate finance business, corporate treasury functions; and
  - discretionary investment managers when communicating with other firms subject to the taping rules.
Soft dollars

- Current rules for use of “dealing commission” or soft dollars introduced by the FSA in 2005 (amended earlier rules)
- Investment manager must not "execute customer orders" through a broker and pass on the broker’s charges to its customers whilst in receipt of goods or services in addition to the execution of its customer orders unless reasonable grounds to be satisfied that the goods or services are related to the execution of trades on behalf of the customers or comprise the provision of research
Soft dollars

- Investment manager must ensure that the additional goods or services being received:
  - will reasonably assist the investment manager in the provision of its services; and
  - will not impair compliance with the duty to act in the best interests of its customers.

- If an investment manager does use dealing commission to purchase goods or services, it must make adequate prior and periodic disclosure to its customers of the arrangements entered into disclosing details of the goods or services that relate to execution and, wherever appropriate, separately identify goods or services that are attributable to research.
Soft dollars - the code

- UK Investment Management Association and London Investment Banking Association have developed a statement of good practice and disclosure code for “dealing commission”
- Code is minimum UK standard for investment managers
- Compliance with the code is generally accepted as compliance with the FSA rules.
- Information required includes details on commission sharing arrangements
FSA Investigations and Enforcement

Robert Hadley
K&L Gates, London
Hedge Fund Managers

- Hector Sants 20 November 2007 – Emphasises importance of market integrity

- Market Watch 24 (October 2007) - FSA comments on market abuse controls at hedge funds – a mixed bag

- Currently - A follow-up programme of visits to assess formally the market abuse systems and controls (especially in relation to inside information) of a range of Hedge Fund Managers
Inside Information

- Mergers and Acquisitions
- Informed Price Movements before some 23.7% of takeover announcements in 2005

March 2007 Updated Measure of Market Cleanliness
FSA Enforcement

- “Bold and Resolute” “Credible Deterrence”
- Market Abuse especially Insider Dealing are Enforcement strategic priorities
- It is a strategic objective to bring criminal cases
- Shift focus for more impact on individuals
- Encourage Co-operation and Self-reporting
Principles-Based Approach

- Principle 1 – “integrity”
- Principle 2 – “due skill, care and diligence”
- Principle 3 – “take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems”.
- Principle 5 – “observe proper standards of market conduct”
  - Code of Market Conduct - MAR
- Principle 6 – “treat [customers] fairly”
PRINCIPLES – BASED APPROACH

Breach of the Principles/Statements of Principle

IS ENOUGH for Enforcement sanctions

- £6.3 million firm/£350,000 individual (Market conduct/skill, care and diligence)
- £4 million (Skill, care and diligence/systems and controls)
Email from analyst to an equity salesman at 6.32pm 24 May
“Good tidbit to pass around.”

Attached email in from third party.
“Hey bud, I think you care on this one, so quick heads up ahead of tomorrow’s analyst meeting.
“Sounds like they’re going to bring down 2005 EPS guidance to $1.98-2.02 (vs current consensus of $2.06. They’re going to talk about DES share back up at 58-59% but spend (mostly R&D) goes up since they made those 4 acq’ns this year, 3 of which came with burn.”
“Don’t want to get in trouble …Keep btwn us for now.”
FSA Enforcement 2008

- Recruiting Criminal Practitioners
- Mounted First Ever Insider Dealing Prosecution
- Strengthening Market Monitoring
- Earlier Enforcement input – before formal referral to Enforcement
- FSA feels investigations taking too long
- FSA will not necessarily give extended preparation time to interviewees
- Cold Calls
- Immunity – want insiders as prosecution witnesses
- Plea Bargaining
Reporting Obligations

- Principle 11
- Specific Rules re firm and Approved Person Changes
- Proceeds of Crime Act 2002
- Suspicious Transaction Reports SUP 15.10.2R
  - Firm obligation to notify reasonable grounds for suspicion that a transaction involves market abuse to FSA without delay
- Auditor Obligation s342 FSMA
FSA Investigation

- FSA Information-gathering Powers
  - Statutory Information Requests
  - Appoint Investigators to Investigate
  - Note:
    - The Skilled Person’s Report
    - Investigations to Assist Overseas Regulators
  - Legal Privilege

- Sanctions/Offences
  - Non-compliance punishable as a contempt s177 FSMA
  - Criminal Offence to falsify/conceal/destroy/give false or misleading information
FSA Investigation

Can’t “Plead the Fifth”
- Financial Services and Markets Act 2000 ("FSMA")
  Sections 171-173 FSMA – can be compelled to answer questions by an investigator appointed by the FSA
  No privilege against self-incrimination
  Section 174(2) FSMA – compelled answers not admissible against the maker of the statement in criminal proceedings or for market abuse
Requests for Information

Confidentiality of Disclosed Material

- Section 348 FSMA 2000 Confidential Information obtained by the FSA not to be disclosed without consent
- But FSMA (Disclosure of Confidential Information) Regulations 2001 (the “Gateway Regulations”) Permit disclosure to certain bodies for certain public function purposes
- Includes overseas regulators/prosecutors
- US approach
FSA Investigation

- Scoping Visit
- Preliminary Findings Letter
- Preliminary Investigation Report (for Regulatory Decisions Committee “RDC”)
- Stage 1 Settlement Letter
- Report to RDC for decision whether to proceed with disciplinary action
- Warning Notice
  - Representations to RDC – Written and/or oral
- Decision Notice
- Financial Services and Markets Tribunal
- Final Notice
FSA Investigation

- Settlement - Discount Scheme
  - DEPP 6.7
    Note at
    http://www.fsa.gov.uk/Pages/doing/regulated/law/focus/discounts.shtml
    - 30% discount if settle at Stage 1
- Mediation
If an Issue Arises DO

- Be Pro-active
  - Manage Notification to FSA
  - Single Point of Contact
  - Internal Investigation
  - Secure Documents
  - Stop Writing!
  - Involve a Lawyer
  - Resource
- Show Active Engagement of Senior Management
- Understand
- Stop the Rot
- Remedy – Especially Customer Losses
- Satisfy Won’t Happen Again
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