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PRICEWATERHOUSECOOPERS

The regulation and distribution of hedge funds in Europe

Changes and challenges

FOREWORD

Hedge funds have captured the imagination of investors – and the attention of regulators. Worldwide regulators, in some cases responding to pressure from investors, are reviewing national regulatory frameworks applying to hedge fund managers, hedge fund products and hedge fund distribution.

The European environment is complex, and becoming more so, as national regulators (and fiscal authorities) adopt differing approaches. The willingness of national regulators to address hedge funds, and particularly the creation in many European countries of domestic-domiciled hedge funds, are major achievements. However, hedge funds have been largely bypassed by recent pan-European harmonisation moves. Meanwhile, a host of broader European issues, ranging from capital adequacy to anti-money laundering to data privacy requirements, will all impact hedge fund managers and require a response.

For any hedge fund manager wanting to promote funds within Europe, understanding the complexities of the European environment is key and knowledge of regulations in one country is rarely enough. Distribution continues to be principally via private placement, due primarily to marketing restrictions imposed by national regulators. To that end, we provide in this paper an overview of the current regulatory environment surrounding hedge funds and their distribution in Europe. We also address expected regulatory developments, examine whether there are lessons to be learned from the US hedge fund regulatory framework, and provide an outline of our vision of the future European hedge fund regulatory model.

What is clear is that there will be substantial regulatory change in the future. For hedge fund managers, running lean organisations and trying to focus on investment in turbulent times, keeping track of these complex and rapidly changing developments is time-consuming. However, the industry should not leave the regulators to make these changes in isolation. Influence and dialogue with the European regulators is vital to make sure that the changes are workable, and will benefit the industry. The challenge is to develop a model that is competitive with the US.

This paper was prepared with input from hedge fund specialists located in the European offices within the PricewaterhouseCoopers' Global Alternative Investment Management Industry Group network. Compilation of such a paper, which covers up-to-the-minute developments across many European countries, requires a high degree of cross-border collaboration, and I am grateful to our international network for their input.

While this information represents our understanding at the time of going to press, given the rapid transition of the European hedge fund industry, the factual data in this report may change quickly. Up-to-date advice should always be obtained regarding current regulations and fiscal rules.

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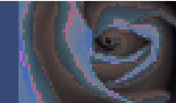

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SECTION 1: EXECUTIVE SUMMARY

Most hedge fund regulation is based on the premise of restricting the sale of interests in hedge funds to limited numbers of qualified, knowledgeable investors. As more investors clamour for access to hedge funds, particularly in current stock market conditions, and regulators develop a deeper understanding of the hedge fund industry, significant changes are taking place.

The European hedge fund industry has grown rapidly to over US$84 billion in assets[1], yet this represents only about 15% of the global total of hedge fund assets. Certainly some of the US dominance of the hedge fund industry is attributable to a stable, yet flexible, regulatory environment that is conducive to managing and distributing hedge funds, and the economies of scale that result.

In contrast, in Europe, an area encompassing many countries and with a gross domestic product of approximately 85% of the US[2], decisions are made at the national level, with limited coordination between national regulators and significant differences in the fiscal regimes in each country. Barriers to distribution are significant, including: cultural differences such as attitudes to savings; tax disparities; differences in interpretation of common EU rules by national regulators; and disparities in national legislation on consumer protection. The marketing of hedge funds, in particular, poses challenges as national regulators struggle with understanding the complexity of the product and their perception that it is inherently more risky than investment in a long-only fund. One concludes that the European regulatory environment is complex but it is changing rapidly.

Our research, which reviewed regulation of the hedge fund industry at three levels, is briefly summarised below:

Regulation of European hedge fund managers

- In most European countries, fund managers are generally allowed to manage hedge fund products and both hedge fund and conventional fund managers operate under the same regulatory regime (with Germany a significant exception). Minimum capital requirements vary from country to country. In some countries, managers can manage offshore-domiciled hedge fund products; in other countries managers are restricted to managing domestic-domiciled hedge fund products only.
- Almost 70%[1] of European single-manager hedge funds are managed from London, despite the fact neither single-manager hedge funds nor funds-of-hedge funds are domiciled in the UK. While London's dominance in hedge fund management reflects its role in the asset management industry generally and the depth of available resources, it is also due to the relatively light regulatory regime applied by the FSA, which classifies most hedge fund managers as "lower risk" because of limited public access to their products.
- More recently hedge fund managers are being established in other European countries, including France, Ireland, Italy and Sweden.

Regulation of hedge fund products

- Most hedge funds are domiciled "offshore" in the jurisdictions of the Caribbean, Bermuda and the European offshore centres (notably Guernsey). Generally, regulation of offshore hedge funds is lighter – there are usually no minimum investment amounts required, so funds are open to all investors, subject to the rules of the country where the product is actually sold. However, offshore centres are tightening their regimes, primarily to comply with anti-money laundering controls and to ensure they are able to compete with the anticipated future demand for European-domiciled funds.

[1] Eurohedge magazine, February 2003

[2] Data per OECD "National Accounts of OECD Countries", 2002 data; Europe includes the EU countries plus Switzerland

- European-domiciled hedge fund products are expanding, with France, Ireland, Italy, Luxembourg, Sweden and Switzerland all permitting the formation of domestic, single-manager hedge funds and/or funds-of-hedge funds, in many cases due to recent legislation. European-domiciled hedge funds are more strictly regulated than hedge fund products domiciled offshore, with restrictions such as minimum subscription amounts, minimum fund sizes and portfolio investment restrictions.

Distribution of hedge fund products

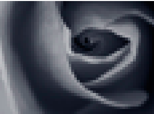
- Hedge funds have generally been distributed via private channels to institutions and high-net-worth individuals (HNWIs), although certain countries have restrictive tax laws that effectively prevent individuals from investing in offshore funds.
- Investors in countries where direct investment in hedge funds is restricted have sought to invest via wrapper instruments such as structured notes issued by banks and insurance companies (with performance tied to that of the underlying hedge fund).
- Domestically-domiciled hedge funds have enabled investors not meeting traditional HNWI criteria to invest in hedge funds, although minimum investment thresholds differ widely in those countries where such products are offered.
- Not all hedge fund managers wish to offer their funds to smaller investors as the additional administrative costs are considered to outweigh the benefits of the additional assets under management.

The European hedge fund market is changing:

Table 1: European hedge fund market trends

Now		The Future?
Managers mainly located in London	Manager location	London still dominant but Paris, Frankfurt, Stockholm, Milan and Dublin attain critical mass
Funds mainly domiciled in the Caribbean, Bermuda and European "offshore" centres	Fund domiciles	Rise of European "onshore" domiciled product
High-net-worth investors and family offices, some institutional investment	Investors	Increased demand from pension funds and life insurers; available to mass affluent and retail investors
Lighter regulation	Products and distribution	Tiered regulation

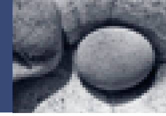
As we look at the success of the hedge fund industry in the US, and, to a lesser extent, the UK, distinguishing characteristics of both jurisdictions, in addition to fund management expertise, are a stable regulatory environment and a "light regulatory touch." A key characteristic is that the regulatory rules for hedge fund managers are clearly set out, and managers can operate their businesses within a flexible framework.



As European countries take the important step toward authorising domestic-domiciled hedge funds, with the associated security of local regulation for investors, it is important that regulatory stability and the “light touch” are kept in mind. To protect the smaller investor, regulators are authorising funds-of-hedge funds where greater diversification can be achieved and the funds-of-hedge funds manager bears a significant responsibility for due diligence.

In the longer run, the hedge fund industry would benefit from harmonisation within Europe on issues such as minimum investment thresholds and portfolio investment restrictions. There are significant signs of pan-European regulatory change, although they do not yet encompass hedge funds. The Product Directive of UCITS III expands the lists of allowable investments but seemingly precludes the establishment of short positions, whether achieved by the use of derivatives or not. This would appear to prevent the introduction of a hedge fund that can be marketed cross-border. The introduction of Capital Adequacy Directive 3 will require all fund managers to move to a more risk-based regulatory capital model. The Committee of European Securities Regulators will coordinate detailed decision rule-making behind the principles set down by the EU Commission, and it has already tackled harmonised Conduct of Business Rules, but there remain significant obstacles to achieving a true pan-European market in financial services of any kind, let alone hedge funds.

Hedge fund managers can play a pivotal role in influencing European regulators. In the current bear market, regulators need to be seen to be considering ways in which investors can obtain access to alternative types of products which may assist, for example, in addressing issues associated with the European pensions "time bomb". Substantial regulatory change is on the horizon, but will it always be beneficial for the hedge fund industry? Hedge fund managers should actively seek to participate in consultations and dialogue with European regulators to influence and shape the rules; workable and beneficial solutions must be developed so that the industry can benefit from a framework that is competitive with the US.



SECTION 2: THE EUROPEAN HEDGE FUND REGULATORY FRAMEWORK

The European hedge funds industry is changing:

- As the regulatory environment changes, hedge fund managers are able to establish operations in Europe in locations other than London – e.g. France and Sweden (where there are prime brokers) and also Switzerland, Italy and Ireland.
- An increasing number of new funds, especially funds-of-hedge funds, are domiciled in Europe (for example France, Ireland, Italy, Luxembourg and Sweden) where the level of regulation of the product is seen to be higher than in the traditional offshore jurisdictions. Regulators are more willing to permit retail investors to invest in a domestic-domiciled fund where local regulation provides an enhanced level of supervision and control.
- Offshore jurisdictions are tightening their regulatory regimes in order to compete with European "onshore"- domiciled funds, and in response to increased focus on anti-money laundering controls as a result of recent Financial Action Task Force (FATF) initiatives and the focus on fighting terrorism.
- While strong demand from HNWIs continues, smaller investors and institutional investors such as pension funds and life insurers are showing increased interest. Pressure from these parties is pushing regulators to review their regulatory regimes and respond accordingly, although each is responding differently.
- Some regulators are trying to protect investors by regulating the type of investor who can invest in a hedge fund; others choose to regulate by minimum subscription level. Certain regulators continue to believe that investment in hedge funds by the general public is premature.

Lessons from the US model

Despite the significant growth in European hedge fund assets in the past two years, European hedge funds are nonetheless believed to comprise only about 15% of global total of hedge fund assets. We believe that, in order for Europe to take full advantage of the demand for hedge fund products and to compete with the US in the hedge fund industry, further significant change to the European regulatory model is necessary. Although there have been attempts in recent years to create greater cross-border harmony, the European market continues to be characterised by barriers to distribution, caused by: cultural differences, including different attitudes to saving; tax disparities; administrative red tape (costs and registration delays, etc); differences in interpretation of common EU rules by national regulators; and disparities in national legislation on consumer protection. The marketing of hedge funds, in particular, poses even greater challenges, as national regulators struggle with understanding the complexity of the product and their perception that a hedge fund is inherently more risky than investment in a "long-only" fund.

In comparison, the US hedge fund industry benefits from a regulatory environment that is conducive to managing and distributing hedge funds. As long as the hedge funds and separate accounts managed by a hedge fund manager total less than fifteen, most managers are able to obtain exemption as "private advisers" from the majority of the regulatory requirements of the Investment Advisors Act of 1940, while the Commodity Exchange Act provides rules only for those hedge fund managers that are registered as commodity pool operators or commodity trading advisers. Similarly, most hedge funds are exempt from regulation under the Investment Company Act of 1940 and the Securities Exchange Act of 1934 providing they are not offered to the public and meet certain other criteria, principally in relation to the number and nature of investors. Compliance with federal regulatory rules in most cases also achieves compliance with state rules and consequently US hedge fund managers are able to conduct business within a flexible regulatory environment which, for most managers, entails minimum regulatory oversight.

The existing US regulatory model for hedge funds is subject to change due to the introduction of the USA PATRIOT Act and the findings of the year-long SEC review of the hedge fund industry. The SEC has yet to announce the results of its review, but it is quite possible that most hedge fund managers will be required to register as investment advisers with the SEC, and that the accreditation standards governing eligible investors may be raised. However, while these changes are likely to result in additional regulations and potentially enhanced costs of compliance for hedge fund managers, they are unlikely to have a significant impact on the regulation of the hedge funds themselves or the ability of the managers to market the funds. The US model of "regulation with a light touch" seems to be here to stay.

We believe that, in order to compete with US hedge fund managers, the regulatory environment in Europe needs to continue to evolve and to move towards the US model with flexible regulation and fewer barriers to distribution. This means that European and national regulators must continue to harmonise the rules between countries by addressing the current regulatory barriers; however, the harmonisation must be workable. Harmonisation in Europe is difficult to achieve, because, although regulators have common concerns about investor protection, in addition to regulatory differences, there are significant differences in the fiscal regimes in each country. Despite the creation of many pan-European government institutions and the advent of the euro, each country still retains the right to levy its own taxes and this fact remains a key barrier to a true European Market.

Changes on a pan-European basis

The original UCITS Directive (85/611/EEC) has already taken over 15 years to help to achieve partial standardisation of authorised investment products (collective investment schemes such as SICAVs and unit trusts), but differences remain in the way that countries have interpreted the Directive. However, regulators now have a different attitude to change, as evidenced by the EU's approval of the Financial Services Action Plan, which sets out a roadmap for change in Europe. The European Commission is supportive of greater harmonisation, and a mechanism exists in Europe – the Committee of European Securities Regulators ("CESR"), a body representing all the European regulators – that allows regulators to coordinate the detailed rule-making in line with principles set down by the EU Commission. This initiative is indicative of the desire by the EU to achieve common standards of regulation.

While CESR has not been requested to look specifically at hedge funds, the European Commission is looking at the use of derivatives in UCITS funds, and there is evidence that the consultation model is working, for example the existence of harmonised Conduct of Business (COB) Rules. Continuance of this trend would imply that the European Commission could usefully look at hedge funds if they could be persuaded to do so. Indeed, we are already seeing significant moves towards harmonisation in the regulation of investment managers through the introduction of the harmonised COB Rules for those firms already subject to the Investment Services Directive, and with the impending introduction of Capital Adequacy Directive (CAD) 3, which will require all fund managers to move to a more risk-based regulatory capital model based on level of activity.

Given the above framework, UCITS III may yet provide a useful framework for regulating European hedge fund products, if changes can be made to the restrictions on short-selling, gearing and the requirements relating to liquidity. By expanding the list of allowable investments, the Product Directive is a step in the right direction for UCITS, although it does not go far enough to benefit the hedge fund industry. Given investors' increased awareness of hedge funds, the hedge fund industry has to decide whether a UCITS hedge fund or a UCITS funds-of-hedge funds is something that they should be providing for investors. If the answer is yes, then the hedge fund industry needs to lobby extensively and quickly to bring about the necessary changes to the UCITS rules.

The commercial and business pressures for change are more concentrated now than they were in the past, and the regulators are aware of the significant pressure on institutions – both as product manufacturers and investors – to demonstrate that they are considering offering, or investing in, alternative investments in order to provide diversification. With a significant number of countries about to join the EU, competition from regulators in new Member States to be "in on the action" will be high; it is believed for example, that one or more of the accession countries is considering the idea of becoming the next Dublin and competing as a low-cost financial centre.

Change by national regulators

Some countries are already creating hedge fund products, although outside of the UCITS framework, for example the developments referred to earlier in France, Ireland, Italy, Luxembourg and Sweden, all of which now have a domestic-domiciled funds-of-hedge funds product with low (or no) investment threshold. Several countries, such as Ireland and Italy, also have domestic-domiciled single-manager hedge funds. In addition, other national regulators are examining this area due to commercial pressures from investors, recent poor stock market returns and the demand for diversification. For example, other hitherto unknown players in the hedge fund market – eg Austria, Denmark and Portugal – are also considering changes to their rules.

In May 2003, the FSA in the UK issued Consultation Paper 185 "The CIS sourcebook – A new approach", which requests the investment management industry's views on proposals to effectively allow an authorised, non-UCITS, UK-domiciled hedge fund, that would be open to certain restricted classes of investors. The FSA appears to be taking the view that the appropriate way to restrict distribution is to restrict investment to certain types of investor (eg classified by net worth) rather than by stipulating a minimum investment threshold. However, the FSA's proposals will only succeed if corresponding changes are made to the UK's tax regime to make such UK-domiciled funds competitive. The UK investment management industry is lobbying the Treasury to bring the FSA and the Inland Revenue together to achieve this aim, and later in 2003 the Inland Revenue is due to consult on changing the tax regime.

We believe that there will be a continuation of the trend of countries authorising domestic-domiciled hedge funds. Offshore centres will continue to exist and offer fiscal advantage, but this will be accompanied by lower levels of regulation, for example lower minimum investment thresholds and less onerous transparency requirements, and consequently some European regulators are less likely to permit funds domiciled offshore to be marketed locally to the general public. Indeed, some managers are already in the process of changing the domicile of certain funds-of-hedge funds products from offshore to onshore centres, such as from the Cayman Islands to Luxembourg, in order to access a greater investor base.

In our view, in the medium term, London will remain the dominant centre for managers of European single-manager hedge funds due to its status as a European financial centre and its access to capital markets. Interestingly, continental European and US banks are continuing to set up prime brokerage activities in London. However, as European countries start to allow the creation of domestic-domiciled single-manager hedge fund products, some market share will inevitably be taken from London by the countries that have a strong capital markets infrastructure – for example France and Germany.

Anti-money laundering rules

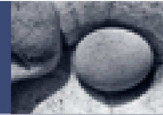
The development and interpretation of the anti-money laundering (“AML”) rules throughout Europe will continue to be a challenge. The move towards domestic-domiciled hedge funds with low entry thresholds will impact on the AML obligations of funds. A greater awareness of the additional risks presented by certain new types of customers and the source of their wealth – for example, political figures that could be associated with the proceeds of corruption – will need to be factored in to client acceptance procedures. The multi-jurisdictional nature of the hedge fund product, its distribution channels and the location of key service providers such as administrators and transfer agents, will present challenges in establishing which entity has the relationship with the investor and, as such, has responsibility for identifying, verifying and monitoring the investor for AML purposes. In particular, the distinction between those entities providing services to the fund (such as an administrator) and those providing services to the investor (for example, an intermediary marketing the fund and introducing investors) has to be considered. The extent of the AML obligations will depend on the scope of the regulatory regime and the definition of relevant regulated activities in each jurisdiction where the fund, manager or administrator is located. From a practical perspective, the consideration of these different jurisdictions’ requirements will be time-consuming to apply. However, further complication arises from the EU Savings Tax Directive which requires a paying agent in one Member State making interest payments to individual beneficial owners resident in another Member State to either collect and pass on to their domestic authorities information on the payment, or to withhold a minimum level of withholding tax from that interest payment.

Data protection rules

Hedge fund managers are also faced with increasing compliance concerns in relation to data protection regulations, designed to protect the privacy of personal information relating to individuals. With hedge fund products becoming available to wider groups of individuals across Europe, getting data protection compliance right will become more challenging and is a significant concern, particularly to European regulators.
Where non-European domiciled funds are offered in Europe, hedge fund managers may need to transmit personal data of individual investors to fund administrators or others in the country where the fund is domiciled or other jurisdictions outside the European Economic Area. Unless those countries are deemed to have in place legislation providing adequate protection of personal data, hedge fund managers will usually have to ensure that they obtain the individual investor’s consent before transmitting the data, and that they have appropriate agreements in place with the data recipient to ensure protection of personal data. Those countries not deemed to provide adequate protection include the USA. This could have a significant impact on European hedge fund managers’ access to the global markets.

Conclusions: action for hedge fund managers

We believe that the SEC investigation and the introduction of the USA PATRIOT Act will result in US regulators moving to regulate the US hedge fund industry more closely. We also see the European regulatory framework becoming more flexible in the approach to the regulation and distribution of hedge funds, and indeed we believe that European regulators are already moving in this direction, with the authorisation of a wider range of non-UCITS products. However, due to differences in the fiscal regimes in European countries and the cautious attitude of many European regulators, the European model will remain much more complex than the US model. Regulators also appear to be moving in different directions on issues such as transparency, where the UK, for example, is likely to go down the route of total disclosure (eg Hedge Fund Distributor Ltd brings you Hedge Fund Manufacturer Ltd’s product), whereas other countries such as Switzerland encourage white-labelling.



Given the global focus on fighting crime, AML rules will become increasingly tight, and this will focus attention on the debate over who is responsible for carrying out the AML checks.

Those involved in the European hedge fund industry do need to take control of shaping the regulatory framework of their industry. For example, they should identify the provisions within UCITS III that require amendment and lobby the EU to ensure that these are considered in time for the revision of UCITS III. Where consultation papers are issued both at a European and national level, the hedge fund industry should actively participate in the consultation process, using trade associations as appropriate. There is evidence that this lobbying process is gaining momentum; for example, FEFSI held a workshop in Dublin during November 2002 to debate the issue of UCITS and hedge funds. The results of this session have been fed back to the EU Commission, and the Commission will review hedge-fund related aspects of the UCITS III Directives when it reports on the application of UCITS III in 2005.

Hedge fund managers should actively seek to participate in consultations and dialogue with European regulators to influence and shape the rules; workable and beneficial solutions must be developed so that the industry can benefit from a framework that is competitive with the US.

SECTION 3: REGULATION OF EUROPEAN HEDGE FUND MANAGERS

In general, European countries do not have specific regulations surrounding investment managers who choose to manage hedge funds. Such entities have to comply with the regulations applicable to any investment manager located in that country. For example, as a general rule, hedge fund managers setting up in the UK have to comply with the same set of regulations as a long-only investment manager; the FSA does, however, generally apply a lower risk classification to hedge fund managers who manage solely offshore funds that are not available to the general public. There are, however, exceptions to this in countries such as Germany where, as long as a fund is not offered on a retail basis, the manager is not regulated.

The statistics included in table 2 show that managers of European single-manager hedge funds are concentrated in certain countries – principally the UK, the US, France, Switzerland and Sweden. Hedge fund managers located in London manage by far the greatest proportion of European hedge funds, measured both by number of funds and by size of assets under management, even though the UK lacks a locally-domiciled hedge fund vehicle and very few hedge funds have their back-office processing performed by a London-based administrator.

London's dominant position in the European hedge fund industry is due to a combination of factors:

- London's position as a world financial centre, with a significant banking infrastructure, its access to capital markets and to stock lending, and the presence of the major prime brokers.
- A favourable regulatory environment in that the full weight of the regulatory regime is not applied where the manager only delivers products and services to non-retail investors.
- A favourable regime for the personal tax position of non-UK domiciled hedge fund managers who live in the UK but who are not required to pay tax on any income or gains which arise outside the UK and which are not remitted to the UK.
- The existence of a set of fiscal rules that allow UK-based hedge fund managers to manage funds domiciled in offshore zero-tax jurisdictions without bringing them into the UK tax net.
- Its location in a strategic timezone, status as a travel and communications hub for Europe and access to a highly competent workforce with financial skills.

However, the last twelve months have seen an increase in the number of single-manager funds managed from France, Switzerland and Sweden.

Table 2 shows the name of the regulator of the investment fund industry in each European country, and indicates the regulatory capital required to conduct business as a hedge fund manager, with comparative information for the US. The minimum capital requirement for a fund manager in most countries is a fixed amount. Exceptions are:

- The UK, France, Guernsey (in some circumstances), and the Isle of Man, where the capital requirement varies based on the manager's annualised expense base;
- Switzerland where hedge fund managers only have to be regulated (and therefore become subject to minimum capital requirements) in certain circumstances; and
- Germany, where there are no regulations for hedge fund managers or hedge funds and therefore a hedge fund manager is not subject to any regulatory rules and there are no minimum capital requirements.

Table 2: Regulation of European-based hedge fund managers

Country	Number of funds (1)	Name of regulator	Minimum capital required to operate as a hedge fund manager
EUROPE			
Austria	3	Finanzmarktaufsicht (FMA)	Varies (2)
Belgium	-	Banking and Finance Commission	€250,000
Denmark	1	Danish Financial Supervisory Authority	N/A
Finland	12	Financial Supervision Authority	€169,000
France	39	Commission des Operations de Bourse (COB)	25% of operating expenses with a minimum of €50,000.
Germany	8	None	None (3)
Gibraltar	-	Financial Services Commission	€50,000 to €750,000, depending on the nature and scope of the activities
Guernsey	-	Guernsey Financial Services Commission (GFSC)	£10,000 or £25,000 plus 3 months expenditure
Ireland	12	Irish Financial Services Regulatory Authority	€625,000
Isle of Man	-	Financial Supervision Commission	Greater of £75,000 net tangible assets or 3 months' expenditure
Italy	5	Bank of Italy; Commissione Naziole per le Societa e la Borsa (CONSOB)	€1,000,000
Jersey	-	Jersey Financial Services Commission (JFSC)	£25,000
Luxembourg	-	Commission de Surveillance du Secteur Financier (CSSF)	€125,000 (Type 2 managers) €1,500,000 (Type 3 managers) (4)
Netherlands	5	Netherlands Authority for the Financial Markets	€226,890
Norway	4	Securities Market Commission	€125,000
Portugal	1	Portuguese Securities Market Commission (CMVM)	€250,000 (5)
Spain	6	Comisión Nacional del Mercado de Valores (CNMV)	€300,000
Sweden	18	Swedish Financial Supervision Authority (FSA)	SEK 1,000,000
Switzerland	36	Swiss Federal Banking Commission (FBC) (if regulated)	CHF 1-10 million (if regulated) (6)
UK	394	Financial Services Authority (FSA)	Usually €50,000 own funds plus liquid capital of 3 months' annualised expenditure.
USA	29	Securities and Exchange Commission (SEC) Commodity Futures Trading Commission (CFTC)	None (7)

(1) Estimated number of European single-manager hedge funds managed from this country at end of 2002; source: Eurohedge, February 2003.

(2) The FMA is only responsible for Austrian banks and Austrian ISD firms, and branches of foreign banks and foreign ISD firms in Austria. If a bank is the manager, the capital requirement is €5 million; if an ISD firm is the manager: €50,000 or €125,000 depending on scope of services provided.

(3) Hedge fund managers in Germany are not regulated and therefore there is no capital requirement.

(4) Type 2 and Type 3 managers manage non-UCITS funds domiciled inside and outside of Luxembourg respectively.

(5) Hedge funds domiciled in Portugal are not allowed. To manage funds other than those mentioned in the local legislation, entities need to request authorisation from CMVM, and there is a restriction on the managing of such funds, even domiciled outside Portugal. In practice therefore there are few hedge fund managers in Portugal.

(6) Generally, hedge fund managers in Switzerland are not regulated unless they manage a Swiss domiciled hedge fund regulated under the Investment Funds Act (IFA) and at the same time act as the hedge fund's legal fund management company. There is currently only one Swiss domiciled single-manager hedge fund.

(7) Hedge fund managers in the USA can apply for a "private adviser" exemption from registration under the Investment Advisors Act of 1940 as long as, among other things, the adviser has fewer than 15 clients and does not hold itself out to the public as an investment adviser (although it is important to note that the anti-fraud provisions of this Act apply to all investment advisers, whether or not exempt under the private adviser exemption). In most cases, each "fund" will count as a client and a "look-through" to the number of investors will not be required. For a US adviser, each client, whether US or not, will be counted; for a non-US adviser, only US clients are counted.
The Commodity Exchange Act provides rules for those advisers that are registered as commodity pool operators or commodity trading advisers; registration with the CFTC is required for managers of funds trading certain futures contracts or commodity options.

SECTION 4: REGULATION OF EUROPEAN HEDGE FUND PRODUCTS

Most non US-domiciled hedge fund products are domiciled in jurisdictions where the fund is not subject to tax – mainly the Caribbean jurisdictions (Cayman, Netherlands Antilles, BVI and The Bahamas), Bermuda and the European offshore centres (where Guernsey, in particular, is a popular domicile for European funds-of-hedge funds).

Regulation of products domiciled in offshore locations is lighter than those domiciled in onshore European jurisdictions, and the set-up time required for an offshore fund is generally shorter. National regulators in some European countries (for example, France, Ireland, Italy, and Luxembourg) have created locally-domiciled hedge fund products, which are subject to regulation in the country concerned. The past year has seen the creation, in particular, of authorised European fund-of-hedge fund vehicles. This is in response to the increase in demand both from institutions, which may prefer to invest in a more regulated and diversified product, and from fund managers wanting to distribute their funds to a wider group of investors.

The approach taken by many regulators in Europe to limiting access of smaller investors to hedge fund investment is to set a limit on the minimum amount of investment. This has the effect of restricting distribution to wealthier investors. The rules of the national regulators differ – in Italy the minimum investment is €500,000 (it has just been reduced from €1,000,000) whereas in Ireland and France it is only €12,500 and €10,000 respectively for funds-of-hedge funds. Other countries, such as Luxembourg, do not specify a minimum investment at all. This approach is different to the US where investors in hedge funds have to meet certain wealth criteria in order to be classified as "accredited investors" (in general, investors need a net worth of $1.5 million to qualify as an accredited investor, or a $250,000 minimum investment).

Table 3 shows which countries have domestic single-manager hedge funds or funds-of-hedge funds vehicles, the minimum investment amount for these funds, and the time taken to set up a fund.

Table 3: Regulation of domestic-domiciled hedge funds

Country	Domestic domiciled hedge fund exists?		Minimum investment amount	Average time taken to set up a fund	Notes
	Single-manager?	Funds-of-hedge funds			
EUROPE					
Austria			N/A	N/A	
Belgium			N/A	N/A	
Denmark			N/A	N/A	
Finland	✔	✔	None	3-6 months	1
France		✔	€10,000 (funds-of-hedge funds), minimum fund size of €160,000	2-3 months	2
Germany	✔	✔	None	N/A	3
Gibraltar	✔	✔	None	3 months	
Guernsey	✔	✔	None	2 months	4
Ireland	✔	✔	€125,000 (single-manager fund) €12,500 (funds-of-hedge funds)	3 months	5
Isle of Man	✔	✔	$15,000 (experienced investor fund) $100,000 (professional investor fund)	1-2 months	
Italy	✔	✔	€500,000	4-8 months	6
Jersey	✔	✔	None	2 months	7
Luxembourg	✔	✔	None	2 months	8
Netherlands	✔	✔	None	4-6 months	
Norway			N/A	N/A	
Portugal			N/A	N/A	
Spain			N/A	N/A	
Sweden	✔	✔	None	3-6 months	9
Switzerland	✔	✔	None	Up to 6 months	10
UK			N/A	N/A	
USA	✔	✔	None	Varies	11
OFFSHORE					
The Bahamas	✔	✔	None	2 months	
Bermuda	✔	✔	$100,000 (Institutional Scheme) None (Standard Scheme)	3-5 days	
BVI	✔	✔	None	6-7 days	
Cayman	✔	✔	None	3-5 days	
Netherlands Antilles	✔	✔	None	1-2 months	

1. **Finland:** There are no portfolio investment restrictions applicable other than there shall be risk-diversification. The overall investment policy, as described in the fund's prospectus, will be examined by the Financial Supervision Authority, which is entitled to refuse certain investment strategies.

2. **France:** Funds-of-hedge fund products will be permitted once the regulations outlined in the COB Statement of Position of 3 April 2003 are implemented later in 2003. The COB has defined specific criteria that should be satisfied by investee funds, in relation to matters such as the legal environment of the fund and to the control over the assets, and non-European domiciles are permitted.

3. **Germany:** At present, German-domiciled hedge funds are not subject to any regulation, and marketing of domestic "hedge funds" (as the term is generally used) is possible without specific restrictions. There is no regulatory term or set of rules for hedge funds.

4. **Guernsey:** The main regulations have been in place since 1990 (with no minimum investment amount) and Qualifying Professional Investor regulations since 1998 which require investors to demonstrate minimum net worth, and provides a lighter regulatory regime. Protected Cell Legislation has proved popular as the assets of different cells in an umbrella are ring-fenced from one another.

5. **Ireland:** Regulations published in December 2002 allow for the formation of Irish authorised retail funds-of-hedge funds. Single-manager funds can be set up as Professional Investor Funds (PIFs) and Qualifying Investor Funds (QIFs) under rules that have been in operation since the mid-1990s. Investee funds can be unregulated schemes (no restriction on domicile); however there are restrictions over the percentage of assets of a fund that can be in unregulated schemes, and various criteria apply to the underlying funds.

6. **Italy:** In April 2003, the minimum subscription was decreased from €1,000,000 to €500,000 and the maximum number of investors was raised from 100 to 200. Units of hedge funds cannot be split to allow any investor to hold less than €500,000.

7. **Jersey:** Regulation by the JFSC is lighter for sophisticated/institutional investor funds, which are considered to be those with investment minimum of £100,000 or where investors fulfil specific eligibility criteria in terms of wealth (net assets).

8. **Luxembourg:** Single-manager hedge funds investing mainly in derivatives have been permitted since 1991. CSSF circular 02/80, issued in 2002, allows for the formation of single-manager hedge funds investing in transferable securities, using leverage and short selling, as well as funds-of-hedge funds. There are restrictions over the percentage of assets of the fund that can be in any single underlying scheme.
   In December 2002, Luxembourg changed its case-by-case hedge fund approval process in favour of a transparent set of regulations for hedge fund managers, whereby an authorised hedge fund manager does not have to seek authorisation of each new fund it launches.

9. **Sweden:** Swedish funds-of-hedge funds can invest only in hedge funds domiciled in Sweden.

10. **Switzerland:** While Swiss law would allow the formation of Swiss single-manager hedge funds, due to IFA restrictions in respect of borrowing, and limited investor demand, there is currently only one single-manager hedge fund domiciled in Switzerland. Funds-of-hedge funds are broadly accepted and set up either as open-ended IFA-regulated investment funds (collective investment contracts), or as closed-ended non-regulated corporate investment companies, usually listed on the stock exchange. Regulated and non-regulated funds-of-hedge funds can invest in non-regulated offshore-based single-manager hedge funds.

11. **USA:** A Delaware LLC can be formed very quickly as long as no regulatory approval is required.

    Investment funds are regulated by the legislation described below – however, as noted in each case, in many cases hedge funds are able to claim exemption from these rules as long as they comply with specific criteria:

    a. The Investment Company Act of 1940 and the Securities Exchange Act of 1934: however, most hedge funds obtain exemptions from registration, by complying with rules which specify a maximum number of investors, where each investor complies with various requirements (such as minimum net worth), and where the fund is offered privately.

    b. Securities Act of 1933: this rule governs public securities offerings in the US, but most hedge funds are exempt as long as they are marketed only to "accredited investors" as defined.

    c. Commodity Exchange Act: many hedge funds are registered as commodity pools to allow them to trade futures contracts or commodity options that require such registration. The rules require registration of the fund's adviser as a commodity pool operator, disclosures to investors and other reporting requirements.

    d. State Blue Sky Laws: these vary from state to state and often require registration and/ or reporting. The state laws are usually satisfied by following the related federal laws.

    e. Employee Retirement Income Securities Act (ERISA): a fund may be subject to the ERISA provisions if more than 25% of any class of beneficial ownership of the fund is held by employee benefit plans.

SECTION 5: DISTRIBUTION OF HEDGE FUND PRODUCTS IN EUROPE

The majority of countries in Europe, until recently, have not allowed the distribution of hedge funds to retail investors. In most cases this has been achieved by specific legislation which prevents unauthorised funds from being distributed on anything but a private basis, and often only to investors who meet certain financial investment limits or are classified as "expert" investors. In certain countries, distribution restrictions have also been achieved by tax legislation that results in a disadvantageous tax treatment for certain offshore funds (eg. in Germany and Austria), while not offering a domestic-domiciled alternative product. However, in most countries, offshore-domiciled hedge fund products have been available to high-net-worth investors – either directly on a private placement basis, or by investing via a wrapper product such as a structured note or life product. The detailed laws surrounding distribution in each country have not been summarised here.

Table 4 summarises the main distribution channels for hedge funds in the major European countries, whether hedge funds are available to retail investors and whether there are tax penalties for investing in foreign-domiciled hedge funds.

Table 4: Distribution of hedge funds in Europe

Country of location of investors (1)	Main distribution channels	FOHF* available to retail public? (1)	Tax penalties for investors on investing in a foreign domiciled hedge fund?	Notes
EUROPE				
Austria	Banks Via wrappers Fund distribution companies	✔	✔ if funds do not have a tax representive in Austria	2
Belgium	Banks By private placements Via wrappers		✔ dividends taxed at 25% compared to 20% for a Belgian public fund; realised capital gains may be taxed if seen as speculative	
Denmark	Uncommon		✔	3
Finland	Direct sales by the management company	✔		4
France	Via wrapper instruments	✔		
Germany	Foreign hedge funds: via banks who are the issuers of wrapper instruments (e.g structured bond hedge fund certificates)	✔	✔ disadvantageous tax rules for direct investment in certain foreign investment funds.	5
Ireland	Private banks Brokers	✔		6
Italy	Private placement	✔	✔ tax treatment for individuals investing in foreign funds is less favourable than in Italian funds	7
Luxembourg	Private banks and Universal Banks	✔		8
Netherlands	Direct sales by managers on a private basis Brokers Via issuers of structured notes	✔		9
Norway	Uncommon		N/A	
Portugal	Uncommon		N/A	
Spain	Uncommon		✔ disadvantageous tax treatment for investment in foreign non-UCITS funds	
Sweden	Direct sales by managers on a private basis			
Switzerland	Via banks (publicly and by private placement) Direct sales by managers (private placements to mainly institutional clients) Via independent asset managers Issuers of structured investments	✔		10
UK	Via IFAs Via wrapper instruments		✔ for funds which do not have distributor status.	11
USA	Historically private placements, but more recently, emergence of registered single-manager and fund-of-hedge fund product which may be sold to a significantly wider investor base	✔		12

* FOHF = Funds-of-hedge funds

1. For minimum investment amounts, see table 3

2. **Austria:** has similar arrangements to Germany – see below.

3. **Denmark:** Danish investors face a strong tax disincentive if they invest in hedge funds. The EU Commission is presently undertaking a study to determine whether the Danish tax rules are discriminatory.

4. **Finland:** Sales of hedge funds in Finland are governed by the Act on Common Funds, and hedge funds are often formed as special common funds. Foreign funds can also be marketed in Finland under the terms of this act. However, if the constitution of the foreign fund only permits professional investors to become unitholders, marketing is governed by the Securities Market Act (eg a prospectus shall be prepared if the fund is marketed to over 100 investors).

5. **Germany:**
   a) If a foreign hedge fund qualifies as an "investment fund" within the meaning of the German law, the public distribution of its units requires permission by the fund regulator (BaFin). This permission will not be granted for a foreign fund. For this reason and the tax reasons named below, foreign hedge funds are repackaged in Germany. There are no limitations for the public distribution of domestic hedge funds ("hedge funds" in the generally used sense of the term).

   b) In Germany, foreign-domiciled hedge funds usually qualify as investment funds within the meaning of the German regulatory and tax rules for foreign funds and, if so, are classified as low-level/ black, medium-level/ grey or high-level/ white funds for tax purposes, depending on a combination of factors such as whether the fund has a local tax representative, whether it has a local listing, and the tax information that it prepares for investors. Investors in low-level funds are subject to an extremely disadvantageous lump-sum taxation, and investors in medium-level funds are also heavily taxed. Some foreign domiciled hedge funds have successfully gained the status as high-level funds in Germany.

6. **Ireland:** Hedge funds domiciled outside Ireland, seeking to market in Ireland, must be approved by the Central Bank of Ireland. The fund must apply in writing providing full information, including details of the arrangements for marketing the units in Ireland. In practice very few foreign domiciled hedge funds have sought to do this. Those that have, have been distributed by way of private placement through stockbrokers to high-net-worth individuals.

7. **Italy:** There is a high minimum investment level of €500,000. The tax treatment for individuals investing in a foreign hedge fund is less favourable than Italian hedge funds

8. **Luxembourg:** Retail investors and pension funds can invest in hedge funds and funds-of-hedge funds domiciled in any country, as long as the funds are approved by the CSSF for public offering. Only funds which are subject to adequate prudential supervision in their country of origin will be approved. Acceptable countries are countries in the EU, Canada, USA, Japan, Hong Kong and Switzerland. The CSSF must pre-approve all new advertisements.

9. **Netherlands:** Foreign funds can be authorised for distribution in the Netherlands subject to the same rules as for ordinary investment funds, which require the fund to obtain a licence pursuant to the Dutch Act on the Supervision of Investment Institutions (*Wet toezicht beleggingsinstellingen*, "Wtb"). This licence is required if the fund is to be distributed beyond a restricted circle of professional parties.
   In summary, the Authority of the Financial Markets of the Netherlands ("AFM") will grant a licence if the foreign hedge fund meets certain requirements relating to expertise and trustworthiness, financial resources, management and the supply of information to unitholders and the public, including a prospectus and continuous reporting. In assessing the requirements, the AFM distinguishes between foreign investment funds which are subject to adequate supervision elsewhere and those that are not subject to adequate supervision elsewhere, with additional requirements being required of the latter category.

10. **Switzerland:** There are no restrictions for retail investors to invest in shares of closed-ended non-regulated listed investment companies (funds-of-hedge funds). IFA-regulated open-ended Swiss hedge funds or funds-of-hedge funds and foreign regulated hedge funds approved for distribution in Switzerland can be sold to retail, high-net-worth and institutional investors based on a formal contract with appropriate risk disclosures. Alternatively, a bank or other professional asset manager can distribute hedge funds and funds-of-hedge funds within the scope of an approved and disclosed formal asset allocation policy based on a discretionary management contract with the client. The distributor of IFA-regulated funds generally is either a FBC-regulated institution or else has to obtain the FBC's approval as a distributor. Furthermore, hedge funds and funds-of-hedge funds not approved for distribution in Switzerland can be sold to high-net-worth, sophisticated and institutional investors on a one-to-one basis, but such funds must not be publicly advertised and promoted.

11. **UK:** In March 2003, the FSA published its conclusions following consultation with the hedge fund industry about increasing the access of retail investors to hedge funds. The FSA concluded that it would be premature at this stage to offer any type of hedge fund to retail investors.

12. **USA:** Persons marketing hedge funds are covered by:
    a. the rules of the Investment Advisers Act of 1940, which governs the use of third party marketers;

    b. State Blue Sky laws and regulations, which vary widely in their scope and are often superseded by federal rules if an advisor is a registered investment advisor (an advisor will often register as a federally regulated investment advisor in order to be subject to one set of federal rules rather than various state rules); and

    c. the rules of the NASD, which regulate the offering of hedge funds by registered representatives of broker-dealers who offer hedge funds.

    Hedge funds are available to the retail public only if registered under the Investment Company Act 1940 and the Securities Act of 1933.

SECTION 6: CURRENT HEDGE FUND MARKET DEVELOPMENTS

Every regulator in Europe is probably considering how to react to the growth in European hedge funds and how to regulate the increased demand by European investors for access to these products. Similarly, fiscal authorities are debating whether changes are necessary.

Pan-European Initiatives

The following developments in the wider European investment management industry are relevant to the hedge fund industry:

UCITS III

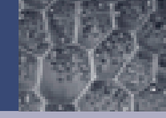
Two new Directives, amending the original UCITS Directive (85/611/EEC), were enacted in February 2002, and together are commonly known as UCITS III. One of these Directives, the "Product Directive", aims to expand the range of UCITS-qualifying investment products beyond those investing solely in shares and bonds.

UCITS III must be implemented in all Member States by February 2004, with the relevant laws and regulations in place by August 2003. However, each Member State can interpret the Directives as it sees fit and in practice there are likely to be differences in approach between countries. No Member States have as yet enacted the legislation to implement the Product Directive except for the UK, in detail, and Luxembourg. By 2005, the EU Commission has to report on the application of UCITS III and propose amendments.

The main provisions within the Directive that may be of interest to hedge fund managers are those surrounding the use of derivatives and funds-of-funds.

- Derivatives: a UCITS-qualifying fund will be allowed to invest in financial derivative instruments (dealt on a regulated market or over-the-counter) for purposes wider than simply hedging, asset allocation and "risk-free" income generation, and it will be possible for European fund managers to launch UCITS-qualifying derivative funds. However, funds will need to comply with a number of constraints that are unlikely to fit with many hedge fund strategies. In particular, the Product Directive prohibits a UCITS fund from carrying out uncovered sales of transferable securities, money market instruments or other financial instruments, or to borrow, other than on a temporary basis (and then only up to 10%).
- Funds-of-funds: a UCITS-qualifying fund will be allowed to acquire the units of certain other collective investment schemes, both UCITS and non-UCITS, provided that, inter alia, no more than 30% of the UCITS' assets are invested in the units of non-UCITS schemes. However, it appears that the regulatory authorities will take a narrow view to defining which non-UCITS schemes are permitted.

In summary, it appears that UCITS III will not allow hedge funds because of restrictions on short-selling, gearing and the requirements relating to liquidity. However, by expanding the list of allowable investments, the Product Directive is a step in the right direction for UCITS but does not go far enough to directly benefit the hedge fund industry.



Capital Adequacy Directive

The future is likely to see a move to a regulatory capital model based in part on gross income following the requirements of the new European Directive, CAD3. The current proposal is to use gross income as the proxy indicator as part of a risk-based regulatory capital model.

Changes to data protection rules

It is unlikely that European Union data protection laws will change substantially in the near future. However, it is important to note that, while data protection in the European Union is regulated under Directive 95/46, much of it is left to the discretion of the national data protection authorities, with the result that the implementation of this Directive varies between Member States. Accordingly, it cannot be assumed that what is permissible in one country is permissible throughout the European Union and companies would be wise to investigate the situation in each jurisdiction. Concerns have been raised over the anomalies existing between Member States relating to the implementation of Directive 95/46 and the European Commission is keen to address these. In the Commission's First Report on the implementation of the Directive, the Commissioner stated that he expects that Member States and supervisory authorities will "make all reasonable efforts to create an environment in which data controllers - and not least those operating on a pan-European level and/or international level - can conform with their obligations in a less complex and burdensome way and to avoid imposing requirements that could be dropped without any detrimental effects for the high level of protection guaranteed by the Directive".
This may well take the form of the introduction of new Industrial Codes of Conduct as anticipated by Article 27 of the Directive.

One aspect that will impact on data protection rules is the treatment of data flowing to countries due to join the European Union upon its enlargement in 2004. In particular, upon accession, there will no longer be any restrictions on the transfer of data to these countries, facilitating data flows accordingly.

Second Money Laundering Directive

Member states have until 15 June 2003 to implement the Second Money Laundering Directive that was finalised at the end of 2001. The impact of the implementation of the Second Directive on the hedge fund industry is likely to be minimal as it is primarily concerned with the expansion of the AML regime to encompass non-financial institutions and professions considered vulnerable to money laundering, including accountants, lawyers and casinos.

A third Directive has also been proposed, depending on the outcome of the current initiative to revise the FATF's Forty Recommendations, recognised as the international standard for anti-money laundering. One of the areas being considered as part of this review is the clarification of the persons and activities covered by the Recommendations. Further developments in this area may also incorporate the specific requirements for hedge funds in the US regulatory regime accompanying the USA PATRIOT Act.

Specific initiatives by national regulators

National regulators in many countries are currently making or considering changes to the regulatory environment surrounding the hedge fund industry, as set out below.

EUROPE

Austria

- Reduction of the tax rate for private investors in foreign hedge funds from 50% to 25%.

Denmark

- The Danish Securities Dealers Association has recently called for regulatory and legislative reform to ease the way for domestic hedge funds. This has been positively received. The Regulator has indicated that they will look at hedge fund legislation in connection with an up-date of the existing regulation for Investment Funds in October 2003.

  Relevant authorities "are interested" in removing what are seen as barriers to a more effective capital market in Denmark, including the effective ban on hedge funds and an inadequate framework for share lending, and the very strong tax disincentive faced by Danish investors if they invest in hedge funds. The Danish tax rules, however, make investments in foreign hedge funds unattractive to individual and corporate investors. The EU Commission is presently undertaking a study to determine whether the Danish tax rules are discriminatory.

France

- Regulations are to be issued by the COB later in 2003 to implement the changes described in its Statement of Position issued on 3 April 2003.

Germany

- In January and March 2003, respectively, the German regulator (BaFin) issued two consultative questionnaires to institutions and hedge fund managers both within and outside Germany, with a view to regulating direct hedge fund investment. The proposed new rules are expected to be published for discussion purposes in 2003 and be enacted in 2004. It is likely that the new rules will:

  – not introduce any restrictions on the investment strategy of a hedge fund;

  – allow public distribution of funds-of-hedge funds, domestic or foreign, to retail investors (new guidelines on registration for public distribution with the BaFin have not yet been published);
  prohibit the public distribution of single-manager hedge funds unless the hedge fund provides for a minimum investment of €1 million; and

  – reduce discrimination against foreign hedge funds via a change in the tax laws.

Guernsey

- Market and regulations are well developed and have been in place and operating effectively, and listings of funds on the Channel Islands Stock Exchange are starting to accelerate.

Ireland

- Revised rules permitting retail investors to invest in funds-of-hedge funds have recently been issued.
- There are proposals for a revision to the rules governing the use of prime brokers to give hedge funds more flexibility in using prime brokers.

- The hedge fund authorisation process is being reviewed.
- A framework for Sound Practices for Hedge Fund Administrators is being prepared.

Isle of Man

- In the 2003 budget, a package of measures was announced with a view to attracting administrators and managers to the Isle of Man via:
  - a zero rate of tax on profits of third party fund administrators and managers of Experienced Investor and Professional Investor funds;
  - VAT exemption on fund management has been extended to these types of funds; and
  - Overseas funds will be exempt from 'dual registration' – ensuring funds that are incorporated in recognised jurisdictions can be administered in the Isle of Man without being subject to further Manx regulation.
- In the longer term, the Partnership Act is to be changed to help attract funds established as limited partnerships, and the Companies (Transfer of Domicile) Act will be modified to enable funds to be transferred to the Island from other major jurisdictions more easily.
- The current minimum subscription of $15,000 is due to be reduced to zero in the near future by Treasury Order.

Italy

- The minimum investment in domestic-domiciled hedge funds was reduced from €1,000,000 to €500,000 in April 2003, and there is pressure to reduce the limit further to €250,000.
- The maximum number of investors in a fund has been raised from 100 to 200.

Jersey

- The proposed changes to the regulatory framework of funds business are expected to take place during mid-2003 and are expected to allow more flexibility in the method of authorising and regulating institutional/expert investor vehicles, to be known as "Expert Investor Schemes". The aim of these proposed changes is to simplify the requirements for authorisation of new fund applications and changes to existing schemes. The proposals fall into two key parts:

  1. The setting out of clear criteria for the categories of either retail or sophisticated investor funds. An investor in an "Expert Investor" scheme will have to invest a minimum of £250,000, and have a net worth of at least £1,000,000 (and comply with certain other requirements).
  2. The establishment of a regulatory framework for service providers to the fund (i.e. the manager) which would allow the manager to self-authorise "Expert Investor" schemes that fulfil stated criteria, ie a regime based on the regulation of the service provider rather than the fund itself. The manager would then be subject to ongoing monitoring by the regulator to ensure that the appropriate procedures continue to be applied in respect of those funds administered.

  These changes are likely to reduce the complexity of the fund launch process and the time taken to launch a fund.

Luxembourg

- In 2002, the CSSF issued Circular 02/80 which clarifies the rules applicable to Luxembourg domiciled hedge funds and simplifies the rules applicable to funds-of-hedge funds.
- Further regulations surrounding the regulation of fund administrators are due to be issued in June 2003.

Netherlands

- Various non-domestic hedge funds have recently been authorised for distribution in the Netherlands.

Norway

- Norway is considering expanding its investment fund regulations in 2004 to allow a wider range of products and thus allowing the establishment of Norwegian hedge funds.

Portugal

- The CMVM, following the UCITS III directive, is working on amendments to the existing legislation. One of the proposed amendments under consideration is the possibility of creating and distributing hedge funds in Portugal. These amendments are unlikely to be ready for final approval until the end of 2003.

Sweden

- The official investment funds investigative committee in Sweden has recently undertaken a review of Swedish investment funds legislation and presented its final report in November 2002. A new law will come into effect in February 2004, and will restrict investment in single-manager hedge funds to "qualified" private investors with an initial investment of at least of SEK 500,000. Other private individuals will, however, be permitted to invest in funds-of-hedge funds which invest in at least five other hedge funds. Non-Swedish hedge fund managers will be able to provide hedge funds to the Swedish market where the fund is approved by the Swedish FSA.

Switzerland

- A current review of overall funds legislation is taking place. A first draft of the new fund legislation is expected in 2003. The new legislation aims to provide an EU-compatible regulatory framework for the whole investment fund industry in Switzerland. Points proposed for the new legislation which may be particularly relevant for the hedge fund industry are:
  - Investment vehicles not regulated under the current legislation (IFA), such as closed-ended corporate investment companies, investment foundations and others, will be included in the scope of the new regulations;
  - New corporate forms of regulated open-ended and closed-ended investment funds will be introduced (e.g., SICAVs, SICAFs); and
  - Distribution of hedge funds and funds-of-hedge funds will no longer require a formal contract with the investor.
- A new draft circular by the FBC in respect of public advertising is currently in the process of being approved. With the objective to provide adequate protection for potential investors, these regulations, among others, will focus on the quality of the relationship between a distributor and an investor. The regulations will also provide guidelines in respect of the use of the Internet. In general, the proposed regulations are likely to make fund distribution more liberal than under current regulations.

United Kingdom

- In March 2003, the FSA published a summary of the comments received on its consultative Discussion Paper 16 "Hedge funds and the FSA". It concluded that:
  - the current regulatory regime was appropriate for hedge fund managers, and therefore there was no need to create a special regime for hedge fund managers or introduce a special supervisory regime; and

– there is no great demand by hedge fund managers to produce or sell retail hedge fund products, nor is there believed to be significant demand from retail investors for access to such products.

The above was an aggregation of comments and does not necessarily reflect the views of separate managers. It is generally acknowledged in the industry that the larger hedge fund managers are interested in having access to retail investors.

- In May 2003, the FSA issued Consultation Paper 185 "The CIS sourcebook – A new approach". This paper requests views from the investment management industry on a new set of regulations for UK authorised collective investment schemes, which includes a new type of authorised, non-UCITS, scheme intended for institutional investors or persons that have been assessed as having sufficient knowledge and experience to understand the details and risk of a more complex product. The new schemes would have a more relaxed set of rules governing their operation, and in particular their investment powers, than for retail schemes. In particular, the following would be allowed:

  – the use of derivatives based on financial instruments and commodities;

  – borrowing up to 100% of net asset value subject to adequate cover and the ability to close out quickly;

  – short selling, subject to adequate cover; and

  – the fund would have the ability to limit its redemptions.

  Given these characteristics, the new fund framework may be suitable for certain types of UK-domiciled, authorised hedge fund, although the FSA does not allow for an unfettered use of all hedge fund techniques. The above rules are open for consultation until October 2003 and the FSA expects to introduce final rules in early 2004 (with a transitional period up until 2007). However, these proposals will only succeed if corresponding changes are made to the UK's tax regime to make such UK domiciled funds competitive. The UK investment management industry is lobbying the Treasury to bring the FSA and the Inland Revenue together to achieve this aim, and later in 2003 the Inland Revenue is due to consult on changing the tax regime.

- Consultations are currently taking place between the Inland Revenue and the fund management industry, including hedge fund managers, in relation to a review of the current UK offshore fund rules, which currently discriminate against investment by UK investors into offshore funds.

- Potential changes to non-domicile tax rules are being considered. An advantage for many foreign hedge fund managers who set up in the UK is that because they are not domiciled in the UK for tax purposes, they do not pay tax on any income or gains which arise outside the UK and which are not remitted to the UK. However, while the Inland Revenue is looking at changes to the regime, it is thought that any changes would only affect non-domiciled individuals who have been resident in the UK for a significant length of time.

USA

- The SEC's fact-finding investigation culminated with roundtable discussions on 14 and 15 May 2003 on a number of topics, including: the structure, operation and compliance activities of hedge funds; marketing issues; investor protection issues; the current regulatory scheme; and whether additional regulation is warranted. The SEC has yet to announce the results of its investigation, but it is possible that certain smaller US hedge fund managers – as well as certain non-US hedge fund managers with US clients – will have to register as investment advisers with the SEC. In addition, the accreditation standards that control which US investors qualify to invest in hedge funds may be raised. While such changes will result in additional regulation for hedge fund managers and potentially enhanced costs of compliance, they are likely to have limited impact on the regulation of the hedge funds themselves or the ability of managers to market hedge funds.

- The USA PATRIOT Act is currently contemplating an expanded definition of "investment company" which, if passed in its current form, will add most hedge funds to the definition of who must comply. However, the draft amendment does provide for an exemption for funds that lock-up capital contributions for at least 2 years. The Act will require funds to put in place an anti-money laundering programme.
- A modernisation of CFTC rules was announced on 13 March 2003. These proposals should promote greater innovation and permit better use of new technologies. The CFTC is looking to modify various rules relating to: expansion of the availability of bunching of orders; addition of new exemptions from registration for CPOs and CTAs; simplification of performance calculation rules; and delegation of the review of Disclosure Documents for certain CPOs to the National Futures Association.

Bermuda

- Administrators will need to be licensed in future, however guidelines are not yet defined.
- Greater streamlining of CIS regulations by the government regulator in order to improve clarity.
- The regulator has recently announced an intention to regulate for improved governance and transparency, although at this stage there is no indication what form this will take.

The Bahamas

- New regulations are due to be issued in June 2003. These indicate a move by the Securities Commission for greater regulation of Bahamas-domiciled or administered funds, as well as the need to strike the correct balance between the traditional light regulation and the global push for greater regulation. Also, protected cell legislation is foreshadowed for the end of July 2003.

Netherlands Antilles

- Further fortification of the link between the Netherlands Antilles and Europe, in that the Netherlands Antilles recently brought in a new supervision ordinance that was developed in conjunction with regulators in the Netherlands. This creates the opportunity for funds supervised by the Central Bank of the Netherlands Antilles and marketed in the Netherlands to possibly benefit from reduced levels of supervision by regulators in the Netherlands.
- Effective 2002, all fund administrators need to be licensed to operate in the Netherlands Antilles and comply fully to all money laundering laws enacted in the Netherlands Antilles.
- Effective 2002, articles of incorporations of Netherlands Antilles based funds need not be in Dutch but can be drawn-up in English. In addition, Netherlands Antilles based funds can elect to be treated as tax-exempt entities under the new B.V. structure.

As can be seen from the above developments, the regulatory environment surrounding European hedge funds is complex and changing rapidly, and the accuracy of the factual data in this report will therefore quickly become out-of-date. Up-to-date advice should always be obtained regarding current regulation and fiscal rules. Contact details for the PricewaterhouseCoopers hedge fund specialist network are given on the page opposite.

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