Getting registered

Simon Thomas of Akin Gump provides a step-by-step guide through the regulatory authorisation process in the UK

One of the important distinctions between the US and the European hedge fund industry is the general requirement for hedge fund managers to undergo prior and ongoing regulatory approval. As things stand, US hedge fund managers can generally set up in business without seeking approval from the Securities and Exchange Commission (although this is currently under review and may soon be a thing of the past). However, in the UK and other EU countries, almost all prospective hedge fund managers must obtain prior approval from the appropriate regulator. In the UK this is the Financial Services Authority (FSA), which must authorise or approve all firms and individuals before they can carry on a regulated activity in the United Kingdom.

The firm's application: A frequently heard complaint from start-up managers relates to the amount of time and effort it takes to become authorised in the UK. In practice, applications take approximately four months from completion of the application forms to final approval, since the application itself is quite complex and must be accompanied by considerable supporting documentation. Completion of the forms themselves usually takes between two weeks to a month and will require the applicant to include a detailed business plan, information on its proposed finances and background on all the key individuals. Don't underestimate the level of information required or the time it takes to gather this information.

For this reason, the application process is often handled by an external compliance consultant with specialist assistance given by the applicant's lawyers and auditors. The FSA encourages applicants to utilise such specialist assistance for, if nothing else, this can speed up the process by helping to ensure that the application is complete from the outset. In addition, the auditor is required to sign off on the financial resources questionnaire. The application is made on the FSA's standard forms which can be downloaded from the FSA web site at www.fsa.gov.uk.

The actual length of the determination process depends upon the complexity and quality of the application. Hedge fund manager applications are generally categorised as 'moderately complex', thereby resulting in an application fee of £5,000. Ongoing fees charged after authorisation are typically calculated by reference to the size of funds under management.

Most hedge fund managers will fall within the category of 'investment management firm' within the EU investment services directive (ISD). This has a number of consequences. If the firm does not propose to hold client money or assets, or to trade for its own account, it will usually have a basic financial resources requirement of €50,000. There is also an additional liquid capital requirement based on liquid capital available for 13 weeks expenditure. Your auditors will help you calculate this.

Individual applications: Alongside the application for the firm itself, applications to become an approved person must be made in respect of key executives, employees and controllers of the firm. A controller will broadly be anyone who owns, directly or indirectly, 10% or more of the applicant or is able to exercise significant influence over its affairs. Bear in mind that applications need to be made for all key persons existing in the 'chain of ownership' all the way up to the ultimate beneficial owner. It can prove time-consuming to obtain all the required information.

In addition, all persons who perform specified key functions, known as 'control functions', need to be approved by the FSA. The FSA grants an application only if it is satisfied that the person is 'fit and proper' to perform the particular function, taking into account such factors as the applicant's honesty, integrity and reputation; confidence and capability; and financial soundness. It also takes into account the separate training and competence requirements of the FSA.

The training and competence regime primarily applies to employees who are engaged in the direct provision of services to clients, such as making discretionary investment management decisions, or advising on, or dealing in, investments on behalf of a hedge fund. An employee must be assessed as competent, by his or her employer, to apply the knowledge and skills necessary to engage in the activity without supervision. The employee must have also passed each module of the appropriate approved examination. It is possible for certain experienced individuals to obtain a full or partial waiver from the examination requirement, although the FSA does not generally grant these without good reason and, even then, it is recommended that the individual take the UK regulatory module of an appropriate exam. It can take some time to ensure that all the applicant's investment managers have passed the appropriate exam. This is therefore an aspect to focus on from the very beginning.

Interview and approval: Once the application has been reviewed and follow-up queries have been dealt with, representatives of the FSA will often visit the manager's offices to interview the key personnel.

If the interview stage has gone well, the decision to grant the application in principle may then be subsequently made by the FSA. The applicant will then be required (if it hasn't already done so) to capitalise in line with the FSA's financial resources requirements. The FSA will then notify the firm that it is authorised and that it will thereafter be subject to its ongoing rules.

Post-authorisation: The FSA expects firms to issue a compliance manual to their employees so that they will have clear guidance on its procedures and the FSA's rules. An authorised firm must make a reasonable effort to ensure that its staff conform with the FSA's rules, statutory restrictions on insider dealing and anti-money laundering requirements. The FSA's conduct of business rules also cover such areas as financial promotion of the hedge fund. It is recommended that all applicants make every effort to familiarise themselves with the appropriate conduct of business rules.

Other authorisations: One of the advantages to authorisation in the UK is the ability to market a hedge fund within the UK to a wider group of persons than is normally the case for promoters of funds which are not FSA authorised. FSA-authorised managers are also able to take advantage of the ISD passport, enabling them to offer their investment services to other countries within the European Economic Area (EEA). This enables European-based managers to set up branch offices in other EEA countries relatively easily.

For UK fund managers, the authorisation process may not be restricted to just achieving authorisation by the FSA. Depending on the structure of the fund and its proposed investment universe, it may be necessary to obtain authorisation of the investment manager and its principals in other jurisdictions (such as wherever the fund is domiciled, listed or administered). In addition, it may also be necessary to register (or obtain an exemption from registering) the investment manager with the Commodity Futures Trading Commission (CFTC) in the United States if the fund will be marketed to US investors and will invest in exchange-listed futures or options. A full CFTC application can take up to three months, so this should be borne in mind from the very outset.

Other European jurisdictions: While the European hedge fund industry continues to be dominated by managers based in the UK, there are an increasing number of funds coming through in other jurisdictions, and notably in Sweden, France and Italy. Each of these countries now has its own rules for registration of the management company as well as for onshore funds. In some other places, it remains difficult to gain onshore authorisation and a number of managers continue to prefer operating as onshore advisers to a management company that is authorised offshore.

Dalton Strategic: Building a multi-fund platform

The Dalton Strategic Partnership was launched in October 2002 to manage not one, but a number of hedge funds. The five initial partners, who had worked together for many years at Mercury Asset Management and Merrill Lynch Investment Managers, started their firm with extensive experience of global asset allocation and a business model designed to support a range of hedge funds and long-only products.

In December 2002, they launched the Melchior Global Macro Fund and the Melchior Global Fixed Income and Currency Fund, managed by Bruno Serfaty and Andrew Fisch respectively. At MLIM, Serfaty had run both the European fixed income team and Total Return teams with Andrew Dalton, while Fisch had been head of the currency team within the fixed income division. The equity long/short Melchior Japan Fund, co-managed by Robert White, the sixth partner, and Ken Nishizawa, was launched in February 2003. Even before the various fund launches, Dalton had recruited a trader and administrator – making for a substantial team.

"We wanted to create a stimulating environment within which specialist investment managers could spark off each other," says Magnus Spence the firm's chief operating officer. "We also provided ourselves with substantial working capital to ensure a robust operating platform. Significant regulatory capital was also required due to the size of staff and the number of funds we are running."

The partners seeded the funds from their own resources as well as money from former colleagues and friends. In addition, as Spence points out: "We were fortunate that we managed to attract a number of private clients, for whom we were able to run segregated accounts. This provided us with an initial income flow."

Dalton intends to expand its private client business, which has already grown to $80 million. In addition, the firm is actively seeking managers to run new hedge funds. As Spence says: "Every time you add another long/short manager, you get an additional benefit of synergy because it contributes to the overall investment debate within the firm."

DALTON FACT FILE

Strategies: global macro, global fixed income and Japanese long/short equity
Launch dates: Dec '02 & Feb '03
Size of funds at launch: macro ($17m), fixed income ($24m), Japan ($8m)
Size of funds at June 2003: macro ($25m), FI ($35m), Japan ($37m)
Start-up costs: £400,000