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Our Ref:
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THIS LETTER HAS BEEN SENT ELECTRONICALLY AND IS UNSIGNED

Dear Ms Rigg,

Response of Dechert LLP to the FSA's CP08/4: Funds of Alternative Investment Funds

Dechert welcomes the opportunity to respond to the matters raised in the FSA's consultation paper CP08/4 on Funds of Alternative Investment Funds (FAIFs).

Dechert is recognised as a leader in its comprehensive and cross-border service offering for managers of retail and institutional fund products in the alternative and traditional asset class and strategies. Our European Financial Services practice operates as an integral part of our global group with some 150 financial services lawyers working throughout our 17 international offices in Europe, the United States and Asia. More than 30 financial services lawyers in our London office focus on financial services.

Dechert welcomes the FSA's general approach to FAIFs. However, if the FAIFs regime is to succeed in terms of providing consumer protection, while also facilitating genuine consumer access to more innovative strategies, there are some key issues to be addressed to make the regime operable in this market, in particular in relation to settlement timings and notice periods, as to which please see our comments in response to Question 1 below.

We also participated in drafting, and have had the opportunity of reviewing in draft, the response of the Alternative Investment Management Association with whose comments we agree.

Our responses to the FSA's specific questions are set out below.

Q1 (a) Do we need to make any changes to the existing NURS repayment standards?

Settlement Period

Applying the T+4 settlement standard to FAIFs would carry a high risk of concentrative and dilutive effects on investors which would be both routine and significant in extent.

Many alternative funds (which would form a significant proportion, if not the majority, of the underlying assets held by many FAIFs) require 2 or 3 weeks from the valuation date to publish net asset values and will generally apply a relatively long redemption settlement period (often 30 days or more). The result of a T+4 standard for FAIFs would be that in a significant proportion, if not the majority, of cases FAIFs would be required to pay redemption proceeds long before a reliable valuation for calculating the redemption price was available. While a T+4 settlement period would ensure swift payment for a redeeming investor, this would be at the cost of creating potential for prejudice of both redeeming and continuing investors due to the need to make payments on the basis of estimated valuations. This would run the risk of a redeeming investor or continuing investors gaining or being penalised for inaccuracies between estimated and final valuations.

While it is true that valuation of many open-ended collective investment schemes involves a degree of estimation, this is normally confined to a small proportion of the portfolio and the past valuations of the underlying securities (on which estimates are normally based) are seldom more than a few days old. For FAIFs investing largely in hedge funds (or other alternative products), the effect would be exaggerated as each underlying fund (or at least the majority of underlying funds) would need to publish their valuations before a current valuation of the FAIF could be carried out. Most underlying funds will publish valuations monthly. Therefore, if a T+4 standard were applied, a large proportion (if not the majority) of the FAIF portfolio would be routinely valued on the basis of estimates, most of which would be a month, and possibly more, out of date.

It is our view that this is a case where imposing the standard normally applied to retail products may actually offer less protection for investors than adapting that standard to the new set of circumstances. We do not understand why a longer settlement period would cause issues concerning the holding of client money that would make it inoperable in practice (such issues presumably exist with any settlement period). We would see the concentrative and dilutive effects that would routinely result from a T+4 standard as a more significant risk for investors.

A longer settlement period would, of course, have timing implications for investors. However, under the proposals, investors would, in any event, have to wait for up to 185 days from the date of deciding to redeem. Therefore a slightly longer settlement period would not be a difficult concept for an investor who has already accepted a long cut-off and could in our view be adequately addressed by proper disclosure.

We believe that a settlement period more closely matching that of the underlying assets would address the above issue. The settlement period would need to be at least as long as the timescale for valuation of underlying funds to enable FAIFs to process subscriptions and redemptions on the basis of a final valuation. In addition the FAIF settlement date should fall a fixed number of business days following the date on which the FAIF would expect to receive redemption proceeds from underlying funds (to allow for clearing of incoming and outgoing balances). We would suggest that around T+40 days would be sensible, particularly as the "typical" 30 day settlement period for underlying funds is often not fixed or referenced to the NAV calculation (see below). A significantly shorter period would cause FAIFs to experience funding difficulties and/or the need to redeem underlying funds an additional month in advance with the result that they would have to hold unnecessary uninvested cash.

Cut-Offs/Notice Periods

The underlying assets of funds of alternative funds (which would include FAIFs) are relatively illiquid due to the applicable redemption notice periods and the relatively long redemption settlement periods. Typical redemption notice periods of underlying funds will be around 30 days but are often significantly longer (some are 2 years) and relatively few are less than 30 days. Settlement periods are typically around 30 days but in many cases the specified period is an estimate (not a fixed obligation) and in some cases the period is a specified number of days following finalisation of the net asset value calculation (which itself is not fixed and often takes 2 to 3 weeks).

For a FAIF to meet its redemption obligations, it would need to generate cash before its own settlement payment date in an amount sufficient to pay redeeming investors. For a typical FAIF, it would take approximately 2 months to realise cash from even its most liquid assets (other than cash) and for many assets this could be significantly longer.

As borrowing powers to fund redemptions are limited and holding excessive cash would create out of the market risk (eroding performance for investors), the logical approach to addressing liquidity management would be to allow the FAIF to impose a notice period (or cut-off) prior to each dealing day which reflected the average notice period required by underlying funds. This would enable the FAIF to calculate its own redemption commitments at the close of business on its cut-off/notice date and to submit matching requests to redeem in approximately the correct amount from its underlying funds.

We believe that such an outcome can be achieved by permitting FAIFs to apply the "limited redemption provisions" in COLL 6.2.19R assuming that the FAIF can make use of the 185 day cut-off in COLL 6.2.16R(7) in the manner described below. In this respect we note the differences in the meanings attributed to "notice periods" and "cut-off point" highlighted in CP08/4 paragraph 3.11. If FAIFs were permitted to apply a cut-off point of up to 185 days in advance of the relevant dealing day and valuation point, this would give adequate time for the FAIF to manage its liquidity (assuming the settlement point is also addressed). (We note that CP08/4 paragraph 3.11 suggests that the cut-off might only be applied in respect of the immediately following valuation day. We assume this is not the intention. However, if the final rules were to reflect this, the likely outcome would be that many FAIFs would reduce their dealing frequency so as not to be unduly constrained in the length of cut-off they can apply. This could have the effect of reducing dealing opportunities for investors in circumstances where the FAIF, but for the rule, might be happy to provide it. For this reason we would suggest that the final rules allow the cut-off period applied in respect of any dealing day to be longer than the dealing cycle of the FAIF.)

(b) If so, what changes would need to be made and why? Should this be extended to all limited redemption NURS or just to FAIFs?

We think it is appropriate to tailor the settlement standard to the nature of the fund and its underlying assets (and other relevant factors). For FAIFs we recommend a 40 day settlement period for the reasons stated above. For other products which can produce valuations with a shorter period we believe a shorter settlement standard is appropriate (assuming this is consistent with other relevant factors to be taken into account).

A redemption settlement period of T+40 days combined with the up to 185 day cut-off point provided for in COLL 6.2.16(7)R, would enable FAIFs to produce accurate valuations on which to calculate redemption payments.

We would propose the following amendment to COLL 6.2.16R(5):

(5) The period in (4) expires at the close of business on the fourth *business day* following:

(a) the later of ~~(a)~~: (i) the *valuation point* at which the *price* for the *redemption* was determined; or ~~(b)~~ (ii) the time when the *authorised fund manager* has all the duly executed instruments and authorisations to effect (or enable the *authorised fund manager* to effect) the transfer of title to the units~~.~~; or

(b) where *limited redemption* applies and a substantial portion of the assets of the *scheme* would not be capable of valuation within four business days following the later of 6.2.16 R(5)(a) (i) or (ii), the later of (i) the close of business on the thirty sixth day following the relevant *valuation point;* or (ii) the time when the *authorised fund manager* has all the duly executed instruments and authorisations to effect (or enable the *authorised fund manager* to effect) the transfer of title to the units.

We would also suggest that the guidance in COLL 6.2.17G(2) is amended to clarify that where limited redemption arrangements apply (i) the cut-off is not required to fall after any preceding valuation point; and (ii) that the cut-off may be set with regard to the liquidity of the whole portfolio and not just the most liquid assets:

COLL 6.2.17(2) Where the authorised fund operates limited redemption arrangements, the cut-off point may reflect the expected length of time required to undertake transactions in the underlying investments having regard to liquidity of all underlying investments provided the 185 day limit in COLL 6.2.16 R (7) (Sale and redemption) is complied with. The cut-off point so determined is not required to be set so as to fall after any *valuation point* preceding the *valuation point* for the redemption to which the cut-off relates.

In addition, as drafted draft COLL 6.2.19R(1) leaves some doubt as to whether FAIFs would be eligible for the limited redemption arrangements.

We suggest substituting the following as clearer text:

"6.2.19R(1) [Deleted text]In relation to a non-UCITS retail scheme: ~~investing~~

(a) that invests more than 20% of its scheme property in unregulated schemes and/or qualified investor schemes; or

(b) that invests substantially in immovables; or

(c) whose investment objective is to provide a specified level of return,

the instrument constituting the scheme and the prospectus may provide for limited redemption arrangements appropriate to its aims and objectives."

Q2 Do you agree with our approach to the issue of master/feeder structures? Are there any other key COLL rules that should be applied? If so, please specify and explain why.

We support the FSA's proposal to allow NURS to invest as feeder funds in other FAIFs.

However, the proposed COLL5.6.10B R and 5.6.10C G would create responsibilities for the NURS manager which are unrealistic and not achievable in practice and would act as a significant disincentive for managers to establish master feeder arrangements. The provision in 5.6.10B R would require the manager of a NURS investing as a feeder fund to ensure that the master scheme **and any scheme into which the master scheme invested** operated on a basis that is consistent with the rules in COLL Section 5.6. Further COLL5.6.10C G would make the manager responsible for failure by schemes held by an underlying master scheme to comply with COLL5.6 in circumstances where the manager is likely to have little or no practical control over them.

We would propose that managers wishing to use a feeder arrangement be required to take appropriate steps to satisfy themselves that the master scheme complies with the rules. Unless the manager is affiliated with the master fund (in which case it would potentially be in a position to exercise such control) this requirement could be satisfied, inter alia, by obtaining appropriate assurances as to compliance from the master and monitoring such compliance on an ongoing basis. We think that if the manager is to have responsibility for the master fund's compliance this should be limited to taking all reasonable steps in the circumstances (but, assuming the manager takes reasonable mitigating steps, excluding matters beyond the reasonable control or knowledge of the manager).

In addition, the meaning of the term "responsible" in this context is unclear and we would suggest that it be made clear that this should not be interpreted to mean "legally liable".

We do not think is appropriate or practicable for managers to be responsible for compliance by schemes held by the master fund beyond a requirement to carry out due diligence and monitoring (unless there are particular circumstances where the manager would be in a position to procure this). This would either place an undue burden on the manager in respect of schemes which, in the main, would operate wholly independently of the manager or unduly restrict the choice of potential underlying schemes.

Assuming there could be more than one feeder fund for a single master fund it would need to be determined how responsibility for failures by that master fund would be borne as between the managers of the FAIF feeder funds.

In addition, while we agree with the overall tone of 5.6.10DG, we think it would be useful to clarify the circumstances where, or extent to which, adequate due diligence will have been deemed to have been carried out in circumstances where one or more of the items listed in that section are not satisfied in part or in full. In particular, the requirement to ensure that the manager of a second scheme satisfies the requirement in FIT might lead to uncertainty as to whether such compliance must be complete or similar in substance.

Q3: What are your views on the proposed strengthened due diligence? Are there any other matters that need to be taken into consideration?

We broadly support the FSA's due diligence approach and share its belief that consumer protection can be achieved through due diligence. We believe that the alternative investment industry is committed to and implements a due diligence approach.

However, we consider that given the potential diversity of types of FAIFs, the proposed due diligence rules run the risk of being over prescriptive. For example, we consider that the proposed rule COLL 5.6.10 E (11) R may require FAIFs to place too much weight on liquidity for redemption purposes as at the expense of other important criteria, when selecting underlying schemes. A FAIF manager should be free to determine an appropriate balance between instruments which he believes will produce the best return, which may in some cases be relatively illiquid, and the need to meet redemption requests.

The proposed rule also refers to the number of underlying schemes the FAIF should invest in. However, the number of underlying schemes may not, in itself, help a FAIF to ensure it can meet its redemption requirements but would need to be combined with other factors such as sectoral diversity. We consider that due to the nature of investment decisions such as this which FAIF managers need to be free to make, higher level principles may achieve better results.

Q4: Do you have any comments on this proposal?

We agree with the comments of the Alternative Investment Management Association in relation to this question.

Q5: Do you have any comments on the CBA?

Dechert has no comments on the CBA.

We would be happy to discuss these points with the FSA. If you have any queries please do not hesitate to contact any of the following members of the FAIF team: Peter Astleford, Stuart Martin, Andrew Hougie, Lucy Frew and Jim Baird on 020 7184 7000.

Yours sincerely

Dechert LLP