

## Hedge Fund Managers

### FSA Part IV Applications (Build your own application pack)

## Application Overview

# Hedge Fund Managers – FSA Application overview

## Introduction

solutions 4 compliance has developed a highly successful hands-on approach to compliance, which delivers innovative, effective solutions, facilitating a positive compliance culture and the development of strong cross-functional relationships between compliance and your business. solutions 4 compliance's objective is to demonstrate how compliance can become a positive influence and to take away the misapprehensions of compliance, the regulations and the Financial Services Authority...

**'...we call this...compliance without complexity...'**

## Pre-Application

solutions 4 compliance can project manage each and every stage of the FSA application process (Part IV permission) to include:

- The initial advice stage involving the planning and structuring of the regulated business.
- Assistance in the completion of the FSA application pack itself.
- The preparation of supporting documentation, including the requisite compliance monitoring programme and compliance manual, which can be tailored to the firm's specific regulatory activities and requirements.
- Ongoing assistance and advice during the FSA's vetting and investigative stage including responding to FSA enquiries and attending FSA site visits, if required.
- Communication with the FSA case officer regarding the firm and the underlying individuals.
- Liaising with third parties, such as lawyers, accountants, IT support etc...to ensure that all relevant aspects of the applicant's business are fully operational, as and when required.

## Post Application

Through its industry affiliates, solutions 4 compliance can provide a complete outsourcing service, covering all of your operational, legal and regulatory requirements...firms can tailor a package to suit their exact requirements from a single menu item to a total package...outsourcing support includes regulatory reporting, management accounting, corporate, HR, IT and legal services through to middle and back-office functionality as required...solutions 4 compliance can provide a flexible, tailored ongoing compliance support service taking into account your own specific compliance resources and your appetite in carrying out the requisite ongoing compliance tasks, and the FSA's own risk-based approach to overseeing your firm and sector...solutions 4 compliance can assist you meeting all of your regulatory responsibilities and obligations in a practical, efficient manner including:

- The establishing the firm's compliance and operational infrastructure specifically to ensure that the relevant regulations are fully incorporated within the firm's operational practices.
- The establishment of the firm's risk-management control structure including the provision of the firm's key control logs and registers.
- The establishment of the firm's regulatory reporting and notifications logs and controls.
- Compliance with the FSA's approved person regime including the establishment of the firm's training & competence scheme.
- Compliance with the FSA's financial promotions regulations, including advice on the establishment of the firm's control log and approval procedures.
- The provision of advice and training on regulatory matters including the relevant anti-money laundering training.
- The establishment of the firm's compliance monitoring programme and plan including the provision of independent monitoring visits carried out in accordance with any specific requirements as specified by the firm or the FSA.
- Ongoing compliance support and services including telephone and e-mail advice line.



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# Hedge Fund Managers – FSA Application overview

## Build your own application pack - Introduction

The following guidelines have been developed for applicant firms who are in a position to apply for FSA authorisation (Part IV permission) through the FSA's build your own application pack. In essence all investment management firms, including hedge fund managers, and corporate finance firms should be able to apply through this process.

Historically, completed applications have taken between four and five months following the sending in of the initial submission; firms should also realistically allow a minimum one-month preparation time prior to submission.

### The Threshold conditions.

Before an applicant firm can become authorised it must be able to satisfy the FSA that they can meet the five threshold conditions. As can be seen from the table below some of these conditions are fairly straightforward, e.g. Legal status, location of offices, whereas some are more subjective, i.e. suitability. It is however important to note that the information supplied must be specific to the nature of the applicant firm, i.e. hedge fund manager, and within the context of the size, nature and complexity of the applicant firm. The following table gives a summary of the threshold conditions:

Threshold condition	Summary of threshold conditions
<b>COND 2.1</b> <b>Legal status</b>	<p>The applicant firm must be one of the following:</p> <ul style="list-style-type: none"><li>• a sole trader;</li><li>• a body corporate (private limited company; public limited company, limited liability partnership);</li><li>• a partnership (limited partnership or other type of partnership); or</li><li>• an unincorporated association; or</li><li>• a banking or insurance firm.</li></ul>
<b>COND 2.2</b> <b>Location of offices</b>	<p>If the applicant firm is a body corporate constituted under the law of any part of the UK:</p> <ul style="list-style-type: none"><li>• its head office and, also if it has a registered office, its registered office, must be located in the UK; or</li><li>• its registered office, or its head office if it does not have a registered office, must be in the UK.</li><li>• If the applicant firm is not a body corporate but has its head office in the UK, it must also carry on its business in the UK.</li></ul>
<b>COND 2.3</b> <b>Close Links</b>	<p>If the applicant firm has any close links (links with other firms or individuals), these must not prevent effective FSA supervision of the applicant firm if authorised.</p>
<b>COND 2.4</b> <b>Adequate resources</b>	<p>The FSA must be satisfied that the applicant firm has adequate resources. The FSA will assess the quality and quantity of the applicant firm's resources regarding its:</p> <ul style="list-style-type: none"><li>• financial resources;</li><li>• management;</li><li>• staff; and</li><li>• systems and controls.</li></ul>
<b>COND 2.5</b> <b>Suitability</b>	<p>The FSA must be satisfied that the applicant firm is 'fit and proper' to be authorised. The FSA will assess:</p> <ul style="list-style-type: none"><li>• the competence and ability of management;</li><li>• the management's commitment to carrying on the business with integrity; and</li><li>• the management's commitment to carrying on the business in compliance with the regulatory regime.</li></ul>



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# Hedge Fund Managers – FSA Application overview

## The 'build your own' application pack

When pulling together an FSA application pack there are effectively four key parts / forms, which require completion: a core details form, a supplemental form, a financial resources pack and a checklist and declaration form.

### Core Details Form

This form requires information for and in respect of the following:

- **Contact details and timings for this application:** Contact details, professional advisors and any timing issues (i.e. does the firm have a specific target)...It is important to note that an application takes on average 4 to 5 months and that although the FSA would, if requested, attempt to complete an application within a shorter time period there is no guarantee that this could be achieved.
- **About the applicant firm:** Principal place of business, statutory details of the company or LLP including registered number, office, date of incorporation, auditors etc...history on the applicant, where relevant... key information on the firm's partners / directors / controllers, who owns the firm etc...
- **Personnel Information:** The organisational structure of the company including details of staff responsibilities and reporting lines. In some cases these individuals may not be known at the time of the application, so firms should use boxes specifying the role that would be undertaken by that individual.
- **Systems and controls:** Information on the firm's systems, off-the-shelf etc...business continuity and disaster recovery procedures...it is important to note that the FSA would not necessarily expect applicant firms to have a fully operational office before authorisation. Firms could however be required to demonstrate that they fully understand their requirements.

### Supplemental form

The supplemental form requires information, which is specific to the type of business that the applicant firm is applying for and has been broken down into the following sub-sections:

- Regulatory business plan
- Scope of permission required
- Financial resources
- Personnel
- Compliance arrangements
- Fees and levies

#### Section 1 Background to Business Planning

There is no longer a requirement for firms to draft a dedicated regulatory business plan instead of which there are now a series of questions within the supplemental form, which are designed to extract the information that was previously disclosed within the regulatory business plan. In order to facilitate the completion of this section it is advisable for firms to produce a 'cut-down' version of a regulatory business plan, whose sections can then be incorporated into the requisite questions within the actual form (see attached pro-forma regulatory business plan).

A firm's regulatory business plan is arguably the only unique document within the whole application pack and should be seen as an opportunity by which a firm can promote its objectives, ideas, skills and rationale for establishing a regulatory firm. The FSA have provided detailed notes on what information is required and it is important that these guidelines are followed.

**Background** - In this section, the firm must submit any relevant information regarding the background to the business and explain to the FSA the rationale and competitive advantages of the proposed business. The firm must identify all the likely risk factors, including the level of competition it will encounter explaining how these risks will be monitored and controlled.

Information to be given might include the following:

- The background to the business.
- Any business opportunities that have been identified together with any reference to a specific target, by type, geographical location etc...
- Any long-term strategies / expansion plans that the applicant firm may have.



## Hedge Fund Managers – FSA Application overview

- The type of regulated activities that the firm wishes to apply for and the experience the principles of the business have in undertaking these activities.
- The background and experience of all individuals performing significant influence controlled functions and how this will assist them in performing this role....Applicant firms are also required to provide details of any relevant qualifications / examinations.

**Proposed regulated activities** – In this section the firm must provide information on the firm's customers (e.g. hedge fund / Unregulated Collective Investment Scheme - UCIS), the type of customers the firm will be targeting and details on the fund's investment objectives, strategies and processes.

Information to be given might include the following:

- Details on the fund, including copies of any fund documentation that is available.
- Details on the types of customers the firm will target to invest in the fund.
- Details on whether the controllers of the firm (owners) will have a direct interest in the firm's customer (fund).
- Details on the operational infrastructure behind the fund, e.g. administrator, primebroker, custodian etc...
- Investment process – a description of investment process itself incorporating details on the target rate of return, frequency of trades, the use of leverage and the types of securities and derivative instruments used etc.
- Information on whether the firm will be managing a UCIS
- Marketing strategy – target investors etc...
- Details on the firm's remuneration, e.g. 2/20
- MiFID business – Whether the firm will be performing MiFID business

**Unregulated business** – Details on any unregulated business that the applicant firm is intending to carry out.

**Passporting** – Does the firm intend to carry out any regulated activities in another EEA state either on a cross-border or branch basis. Firms that intend to carry out regulated activities within the EEA are required to provide details of the scope of these activities and in which EEA countries they intend operating in.

**Outsourcing** – Firm's must submit all the information about any arrangement with third parties in connection with its regulated activities and explain fully how these activities will be operated. It is important to note that firms cannot contract out of their own regulatory obligations and therefore it is vital that firms demonstrate exactly what steps they have taken, and will be in place including contingency plans, where regulated activities are undertaken on their behalf.

**Treating Customers Fairly (TCF)** – Firm's must provide details on what arrangements are in place in respect of their overriding obligations under TCF and specifically how they can deliver and demonstrate compliance with the six outcomes for consumers.

**Incapacity of Key staff Target Market and Marketing Plan** - In this section firms must submit full details about what arrangements the firm will have in place to safeguard the interests of customers in the event of absence, illness, disability or death of any essential member of staff. Firms must also provide details of any locum arrangements that are in place, i.e. where the firm has a single individual performing the CF30 controlled function (pre 01 November 2007 referred to as CF21 / CF27) the FSA requires that they establish back-up contingency plans with another regulated firm, or individual.

**Business risks** – Firms are required to prepare and maintain a contingency plan that deals with the applicant firm's key risks, with reference specifically to Internal controls firms must undertake a sensitivity analysis of various scenarios and their possible outcomes (i.e. reduction or large increase in business), loss of key staff etc...

Information to be given might include the following:



# Hedge Fund Managers – FSA Application overview

## External risks

- Competitive risk – Identify competitors and assess their reaction to the applicant's presence in the market, if applicable.
- Concentration risk.
- Consideration should also be given in respect of the following factors and their possible impact (if relevant): e.g. large scale local redundancies, economic recession, low / high interest rates and a limited demand for products / services.

## Internal risks

- Financial risks.
- Key man risk (locum arrangements).
- Investment risk.
- Operational risk.
- Compliance risk.

**Scale of business** – Firms must give an indication of the scale of their business, number of customers etc...both at authorisation and at 6 / 12 months after authorisation.

**Hedge Fund managers** – Hedge fund managers now have a separate section to complete which requests information on their activities in respect of:

- Whether the applicant is a fund of funds manager.
- Will the applicant be managing any other funds in addition to hedge funds
- Whether the applicant was formed under the umbrella of an existing regulated firm.
- Whether it will be using leveraged instruments.
- Details of the fund's auditor.
- Whether the manager is planning to invest in distressed debt, illiquid emerging market instruments or mortgage-backed securities.
- Side letters, and whether the firm intends to use them.
- Side pockets, and whether the firm intends to use them.
- Does the firm intend to launch additional funds over the course of the first two years

## Section 2 - Scope of Permission required

**Scope of permission notice** – A firm's Scope of Permission Notice (SOP) is a contract between a firm and the FSA, which outlines exactly which activities a firm is authorised to undertake. It is vital that an applicant firm's SOP is correct, as errors could result in firms breaching the FSA's regulations. The FSA have developed a permission profile which must be used to indicate the regulated activities and investment types that the firm is applying for. There are also additional questions on whether the firm intends to: hold client money, carry out corporate finance / venture capital activities, whether the firm will be exempt from MiFID and the extent of any additional limitations that the firm wishes to have in place.

## Section 3 – Financial Resources

In order for the FSA to satisfy itself that an applicant firm is in a position to meet the minimum capital requirements, both from the date of authorisation and on an on-going basis, firms must provide the following information:

- Opening and closing balance sheet.
- Forecast year one profit and loss statement.
- Forecast year one cash-flow analysis.
- Projected regulated capital and regulatory capital requirement calculations with supporting assumptions.

Previously a firm's financial resource questionnaire had to be signed-off by the firm's auditors. Although this is no longer a requirement it is likely that firms will require assistance from their auditors in compiling all of the information required.

**Financial resources explanation** - All FSA applicant firms will be required to maintain a minimum capital requirement. Generally, for investment management firms this will be 25% of



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## Hedge Fund Managers – FSA Application overview

the projected expenditure of the company over an initial twelve month period (see ICAAP comments below). Therefore, if the projected expenditure of the company (including payroll, premises costs, communications costs, etc.) but not including discretionary bonuses for the company is £500,000, then the financial resources requirement would be £125,000. As a general rule, this amount will need to be paid in to the company by its shareholders as share capital and will need to be maintained as liquidity within the business.

It can be partly funded by way of preference shares or subordinated loan. The sum paid in by the shareholders will need to be considerably in excess of this minimum requirement as a number of items are deducted from capital in ascertaining if the test is met at all times. These would include any losses, expenditure on fixed assets, a rent deposit and certain illiquid investments. Broadly, the requirement must be met by having sufficient cash in the business at all times following authorisation.

**Credit risk / Internal Capital Adequacy Assessment Process (ICAAP)** – Under the Capital Requirements Directive, a Firm's minimum regulatory capital requirement will be calculated with reference to both Pillar 1 and Pillar 2 capital. Pillar 1 capital is normally an amount equal to  $\frac{1}{4}$  of a FM's annual expenditure, (referred to as its' fixed overhead requirement [FOR]). Pillar 2 capital is calculated with reference to an ICAAP, which is a methodology by which a firm's senior managers assess and manage their business risks through; the documentation of the key risks attributable to the firm's operations, how it manages those risks and what (if any) additional capital it needs to set aside because of those risks. Any additional capital that may be required as a result of carrying out an ICAAP is referred to as Pillar 2 Capital. The reality behind these requirements is that most well-managed hedge fund managers, which do not have a complex structure, will find that their minimum capital requirements will be very little, if at all, in excess of their Pillar 1 capital. solutions 4 compliance has developed a pro-forma ICCAP which can be used to facilitate this process. It is important to note that firms must complete an ICAAP but are not required to provide a copy of this unless it is requested by the FSA.

### **Section 4 – Personnel**

The FSA need to be satisfied that the applicant firm has staff of adequate quality, skills and experience to ensure that it meets both the requirements of threshold condition 4 (adequate resources) and threshold condition 5 (suitability). No staff can perform a controlled function until they have been formally approved by the FSA and all approved persons are subsequently required to comply with the FSA's statement of principles and the approved persons' code of practice.

- Key Staff - Confirmation on which individuals within a firm will be taking the positions of: CEO, directors, partners, compliance officer, money laundering reporting officer, Investment advisor / managers etc..
- Form A – All individuals wishing to perform a controlled function must complete a Form A 'application to perform controlled functions under the approved persons regime'.

### **Section 5 – Compliance arrangements**

The FSA are ensuring that the applicant firm has the appropriate compliance arrangements in place in order for it to meet its regulatory obligations. In order to satisfy these requirements, applicant firms are required to have in place:

- Compliance procedures – Firms must confirm that they have documented compliance procedures in place, although applicant firms are no longer required to provide copies of these procedures with the application itself.
- Compliance monitoring programme - Firms must have in place a detailed monitoring programme, which must be sent with the application.
- Compliance arrangements – Firms must confirm that all senior management of the applicant firm are aware of and understand the compliance procedures.
- Financial crime – Firms must provide details on what arrangements the firm has in place to counter the risks that it might be used to further financial crime.
- Market Conduct – Firms must briefly describe the steps the applicant firm has put in place to counter the risk that it or its staff may engage in activity which constitutes market abuse.

### **Section 6 – Fees and levies**



## Hedge Fund Managers – FSA Application overview

The FSA require this information in order to calculate the applicant firm's fees. Information required includes an estimate of a firm's funds under management (12 months after authorisation). There is also a requirement to provide information for and in respect of the Financial Ombudsman Services (FOS) levy and the Financial Services Compensation Scheme (FSCS). Applicant firms, such as hedge fund managers, which only deal with 'professional investors' will not normally be required to contribute to the FOS and FSCS schemes on the basis that they do not deal with customers who are 'eligible complainants'.

### Checklist and Declaration

The checklist and declaration form is made up of three sections:

- Section 1 – Application fee
- Section 2 – Documents for the application
- Section 3 – Declaration

**Section 1 / Application fee** – Details on the fees required are given within the notes section. Hedge fund manager applications are considered to be moderately complex and therefore a cheque made out to the FSA for £5,000 must accompany the application form.

### **Section 2 / Documents for the application**

**Controllers** - All individuals / trusts or corporates who own 10% or more of a regulatory firm are defined as controllers and are required to complete a controllers form (this could also encompass a situation where although less than 10% ownership was held, they were able to exert a significant influence over the management of the firm). Controllers' forms are relatively straightforward, but their completion may be complicated where ownership is held through off-shore beneficial trusts or companies i.e. with an LLP, one would give details of the members of the LLP. If any trusts or companies are involved, one would need to give details including copies of trust deed or memorandum and articles of association...there are a number of specific controllers forms that are structured in accordance with nature of the corporate ownership, i.e. individual, trust, company etc...

**Compulsory supporting documents** - Firms must provide all relevant documents requested including a draft prospectus (where available), IMA, a permission profile and the requisite financial resource spreadsheets. It is important to note that applicant firms will not be authorised until the firm has provided proof that they are sufficiently capitalized; however firms can provide this proof / capital at the end of the application process. The requested documents are, where relevant, cross-referenced to the actual questions from the previous forms, i.e. core or supplemental forms. Documents sent must be originals.

**Compulsory self-certified documents** – Applicant firms are certifying that these documents have been prepared, i.e. full business continuity procedures and documented compliance procedures, and are available for immediate inspection, if required.

**Section 3 / Declaration** – Applicant firms are required to make a declaration in respect of the application. The signatories required are dependent on the type of application, e.g. a partnership (two partners).

**Additional application forms** - There are also two additional further forms, which may need completion: a disclosure of significant events form and an owners and influencers appendix. These forms would however only be required where the applicant firm had previously traded or where the ownership of the applicant firm is outside of the firm's directors and partners.