

Hedge Funds in Spain

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The new rules



The long awaited Regulations on Collective Investment Schemes (CIS Regulations) (Royal Decree 1309/2005, of 04 November), which came into force on 09 November 2005 set out for the first time a legal framework for hedge funds (HFs) and funds of hedge funds (FOHFs) in Spain.

The regulatory framework has now been completed through the enactment of two pieces of secondary legislation:

- a Ministerial Order from the Ministry of Economy and Finance, of 25 April 2006 (the "Ministerial Order")
- a Circular approved by the CNMV (the Spanish securities markets and CIS regulator) on 03 May 2006 (the "Circular"), which came into force on 17 May 2006.

The main aspects of interest for the hedge fund industry in this package of measures (the "New Rules") are outlined below.

Domestic Hedge Funds

The New Rules create a specific status for HF type products (named IICs de Inversión Libre, literally "free investment CIS"), which can be

marketed only to "qualified investors", as defined by the local provisions implementing the Prospectus Directive (which were enacted the same date as the CIS Regulations and came into force on 17 November 2005).

Qualified investors are:

- legal entities which are authorised or regulated to operate in the financial markets, including: credit institutions, investment services firms, other authorised or regulated financial institutions, insurance companies, collective investment schemes and their management companies, pension funds and their management companies, commodity dealers, as well as entities not so authorised or regulated whose corporate purpose is solely to invest in securities
- national and regional governments, central banks, international and supranational institutions such as the International Monetary Fund, the European Central Bank, the European Investment Bank and other similar international organisations
- high net worth companies and

other legal entities

- certain SMEs (small and medium size enterprises) which have their registered office in Spain and who opt to be treated as qualified investors
- individuals who are resident in Spain and who expressly opt to be treated as qualified investors, if these persons meet at least two of the following three criteria:
 - the investor has made significant trades on securities markets at an average frequency of at least, 10 per quarter over the previous four quarters
 - the size of the investor's securities portfolio exceeds €0.5m
 - the investor works or has worked for at least one year in the financial sector in a professional position which requires knowledge of securities investment.

Main features

The main features of domestic HFs are as follows:

- **investment powers:** HFs can invest in all categories of financial assets although the investment strategy must meet liquidity, diversification and transparency requirements laid down by the law as basic

principles for collective investment

- **leverage:** HFs are subject to a maximum leverage of five times the net asset value of the fund. For these purposes, temporary assignments of assets, financing received through simultaneous transactions and financing from stock loans, as well as derivative leverage are not taken into account, though any such additional means of leveraging the fund will need to be disclosed in the fund's prospectus
- **minimum number of 25 shareholders,** which can be met within one year from the date of the HF's official registration with the CNMV. Any subsequent fall below this level must be remedied within one year to avoid revocation of the authorisation granted or mandatory dissolution
- **a minimum subscription level of €50,000**
- **pledged assets:** no restrictions on the proportion of a fund's assets which may be pledged. However, there are special rules governing the assets provided as collateral by HFs, when receiving financing from prime brokers – see below
- appropriate **risk management systems** need to be implemented, including periodical stress testing
- **quarterly, semi-annual and**

annual reports must be made public and provided to investors, in similar terms to those applicable to standard CIS in Spain with specific content requirements

- **quarterly NAV publication and liquidity requirements** except where the strategy involves specific types of investments which justify less frequent NAV publication and/or liquidity periods, in which case NAV publication and/or liquidity can be provided on a six-monthly basis
- managers may also provide investors with preliminary **NAV estimates** and reconciliations between these preliminary estimations and definitive quarterly or six-monthly calculations must be shown in the relevant quarterly, semi-annual and annual reports, where differences exceed 10%
- **asset valuation:** in addition to the general guidelines applicable to all financial CIS in Spain, specific guidelines have been also approved by the CNMV for HFs, eg investments in assets which are particularly illiquid
- **monthly reporting obligations** with the CNMV are established, including financial statements, statistical information and detailed information on the investment portfolio. Financial

statements must comply with general accounting rules applicable to CIS investing in financial instruments and must be reviewed by the fund's custodian prior to the monthly submission to the CNMV

- **prime brokerage:** regulation of these activities now provides more flexibility than in the initial drafts of the Circular. Such flexibility is granted on the basis, amongst others, that financing arrangements including collateralisation of the fund's assets with the right to dispose of them ("rehypothecation") must be entered into with prime brokers which are financial institutions subject to supervision in a OECD jurisdiction. Control measures are established which are aimed for instance at ensuring that the custodian and, if applicable, the administrator periodically receive appropriate information about the status of the collateral provided and the liabilities to which such collateral relates. The fund manager must also disclose in the prospectus and periodical reports the identity of any prime brokers with which arrangements are agreed, as well as details of their credit-rating and the maximum level of assets collateralised which can be rehypothecated by the prime broker.

Domestic Funds of Hedge Funds

Domestic FOHFs are also envisaged under the New Rules (IIC de IIC de inversión libre). As opposed to domestic single strategy HFs, these do not have any restrictions in terms of marketing, i.e., they can be marketed to all types of investors, including retail.

Main features

The main features of these schemes are as follows:

- **investment criteria:** A FOHF must invest at least 60% of its assets either in domestic HFs, in similar foreign HFs or in investment companies, portfolio companies or similar structures (such as managed accounts) whose investment principles and rules are similar to those of domestic HFs or which are aimed at replicating HFs. Any such foreign HF or structure, must be either domiciled in an OECD jurisdiction or managed by a fund manager subject to supervision in an OECD jurisdiction
- **synthetic exposure** to HFs through investment in a derivative the underlying of which is a HF (or similar structure) will also qualify for the purposes of computing the minimum threshold of 60%

- **diversification:** No more than 10% of its net asset value can be invested in a single HF. Accordingly, each fund must diversify its investments by holding at least 6 underlying HFs, (where the fund keeps its investments in HFs at the minimum of 60% of its funds), or at least 10 underlying HFs, (in the case of a fund which elects to invest 100% of its assets in HFs)
- **investment in other FOHFs** is significantly restricted in order to avoid "cascade risks"
- the principles and criteria for **selection of underlying HF investments** must be agreed by the FOHF's manager with the custodian. Due-diligence exercises in respect of the underlying HFs and their managers must meet a minimum number of requirements, which are listed by the CNMV
- **quarterly NAV** publication and **liquidity** requirements also apply to FOHFs subject to an exception where required due to the specific type of investments in which case, NAV publication and liquidity can be provided on a six-monthly basis. Where no definitive valuation of a specific asset (underlying fund) is available on the redemption date, partial redemption (only in respect of that portion of the

fund's assets which is capable of definitive valuation on that date) is allowed, with the obligation to complete the redemption payment to the investor at the nearest time in which the relevant asset can be definitively valued.

Save for the foregoing specifications, FOHFs must abide by the general rules set out for domestic funds (for instance in terms of eligible assets, risk diversification, leverage, etc.).

General Provisions: (both HFs and FOHFs)

- no restrictions apply in terms of **fees**, i.e. limits on management, custody, subscription and redemption fees set out for other types of CIS do not apply to HFs
- **risk warnings**: each investor must acknowledge in writing, prior to making an investment, the specific risks that are involved in investment into a HF. The CNMV has approved the specific form of wording
- a **simplified prospectus** will be required (similar to the document used for UCITS) and both the full and simplified prospectuses are subject to higher information disclosure standards than standard domestic CIS. Of particular relevance are the requirement to include details of the investment strategies and the risks inherent in such strategies,

the risk profile of the fund and its prospective investors, the general principles and criteria for the selection of underlying HF investments, the minimum notice period required for redemptions and detailed description of the fee structure. Risks warnings must be highlighted in all advertising materials as well as in the fund's prospectus.

Fund Managers

Managers of domestic HFs and FOHFs are subject to certain requirements in addition to those applicable to standard CIS managers, including stricter capital requirements. These are currently set at 4% of the average gross fee income earned by the HF or FOHF manager over a three year period, in addition to the standard CIS amount (€300,000 plus any increased asset-based requirements which apply by virtue of the level of funds under management and other circumstances).

The New Rules specifically focus on the need for enhancing the requirements for systems and controls including risk management, personnel and measures to preserve the independence and reliability of the NAV calculation.

In addition, HF and FOHF managers must use appropriate procedures for the selection of investments and

custodians will play an important role here, since managers will have to agree such procedures with them.

Outsourcing

Importantly, the New Rules contain provisions regulating outsourcing (delegation) of duties by fund managers. In this regard, the following principles will apply:

- delegation must not result in the manager becoming a shell company without minimum substance; in fact, where delegation takes place, the manager must retain sufficient means to control the activities of its service providers in an appropriate manner, and must adequately document such means of control
- delegation of the core investment management function should now be possible although this is subject to authorisation by the CNMV, as is delegation of certain other core functions (eg fund accounting, valuation and NAV calculation and regulatory compliance monitoring)
- the activity of investment management can only be delegated to another authorised fund manager or to an investment services firm authorised to carry out portfolio management under the ISD (or, in future MiFID), provided that

such entities comply with equivalent conditions to those required for domestic HF managers in terms of specific resources, knowledge and expenses to carry out this activity and to properly evaluate the risks they may incur

- administration services cannot be delegated to the custodian or to the prime broker
- in all cases, the outsourcing contract must meet certain additional standards which are aimed at facilitating supervision by the CNMV and at the same time at strengthening the triangle of reconciliation between the manager, the custodian and the prime broker in respect of cash and securities positions
- any non-Spanish manager to whom the investment management function is delegated must be domiciled in an OECD jurisdiction, subject to prudential supervision and offer equivalent guarantees to those required of local fund managers. Furthermore, where it is a non-EU jurisdiction there must be a bilateral memorandum of understanding (“MOU”) in place between the CNMV and the regulator supervising the delegate.

Finally, it should be noted that the New Rules do not provide specific regulations for non-Spanish managers wishing to set up a hedge fund management business in Spain.

Where such managers are authorised in an EU member State as standard CIS managers, the EU passport under the amended UCITS Directive should (in theory) be enough to passport these managers into Spain as standard fund managers, either by setting up a Spanish branch or even on a cross-border basis (free provision of services regime), but such passport does not currently cover the additional activity of management of HFs (or FOHFs). Presumably, the CNMV will require those managers to comply with further specifications.

Marketing of non-domestic hedge funds in Spain

Despite the New Rules, the position on this remains substantially the same, i.e. non-solicited sales of non-Spanish funds will still be permitted but any form of ‘commercialisation’ or solicited sales would remain prohibited unless the fund is registered.

As a consequence of the recognition for the first time of domestic HFs, the rules regarding registration of non-Spanish funds for their commercialisation (marketing) in Spain have been expanded to include HFs. Such funds should (in theory at least) be capable of being registered with the CNMV provided that they can prove that they are equivalent to domestic HFs, i.e. if they comply with similar criteria to those hedge funds which may be

established locally (e.g., maximum leverage of 5 times its NAV, minimum subscription of at least €50,000, at least quarterly liquidity and NAV disclosure, etc.).

The CNMV will, however, still be entitled to deny authorisation for the registration of a foreign hedge fund where the Spanish regulator believes that its jurisdiction of incorporation (or that of its manager) does not offer prospective investors a level of protection equivalent to that provided in Spain.

As a result, a HF domiciled in an off-shore territory (such as the Cayman Islands) could be prevented from seeking authorisation for marketing to Spanish investors, even if it has a manager which is effectively subject to appropriate supervision in an OECD jurisdiction. Whether a Cayman Islands based fund with (for example) a UK-based investment manager could obtain registration, will need to be discussed with the CNMV on a case by case basis although there seems to be scope for this.

With all that in mind, international players in the HF business wishing to actively market HFs in Spain will have the following options: to establish a local HF business (incorporating domestic HFs); to market their HFs through Spanish FOHFs or to find other suitable indirect ways for their sale in the Spanish market.

Taxation of HFs

Spanish resident investors in domestic HFs will be able to benefit from the special tax treatment applicable to domestic funds as well as to non-Spanish UCITS which are registered with the CNMV for marketing in Spain. The main features of this tax treatment are currently as follows:

- deferral of taxation until redemption/sale of units/shares, typically with 15% withholding rate
- 15% flat rate of taxation for individual investors in respect of holdings exceeding one year
- availability for individual investors of the tax deferral mechanism for switches between qualifying funds (which allows individual investors to switch from one qualifying fund to another without triggering capital gains tax).

From an international perspective, and given that no changes have been incorporated to clarify the taxation of non-Spanish non-UCITS, the situation for non-Spanish domiciled HFs seems shrouded in the same uncertainty as previously: they are not expressly included in the scope of application of the

aforementioned special tax regime for domestic funds and non-Spanish UCITS, even when they are registered with the CNMV for marketing into Spain. Consequently in certain cases there is a potential risk that investors would be taxed under income attribution tax rules which would trigger effective taxation on a yearly basis (at marginal rates for individuals), as opposed to the favourable treatment for domestic funds and non-Spanish UCITS, as outlined above.

Furthermore, most hedge funds, which are domiciled in tax haven territories (as per Spain's black list of tax haven territories, which currently includes for instance the BVI and the Cayman Islands), will still be penalised by the special tax regime contained in Spanish Personal and Corporate Income Tax Laws whereby Spanish resident investors (both individuals or corporates) will be presumed to obtain a yearly taxable income of 15% of the fund's net asset value, unless they are able to show otherwise.

Further tax regulations would therefore be welcome to open the Spanish market to a wide range of foreign players without the need of setting up domestic structures or without the current level of uncertainty in certain cases as

regards the tax position of local investors. Although nothing is definite at this stage, a major tax reform is planned for 2007 – which will represent a significant change in the taxation of investment and savings products for individuals and this might be a good opportunity to introduce the required tax developments.

Some open points for the international HF industry

As commented above, and aside from the tax standpoint, there are several aspects of the new rules concerning international players in which the opinion of the CNMV will need to be tested. Amongst these, the following may be mentioned in the first instance:

- the position of the CNMV in relation to the marketing of off-shore HFs into Spain (i.e. its criteria for obtaining authorisation)
- the CNMV's position as to the requirements for HF managers (which will be also relevant to foreign managers wishing to begin operations in Spain)
- further consideration of the position of investment advisors. The New Rules do not include any specific reference to this type of entity commonly used in off-shore HF structures. One of the demands of the market was to have some express recognition of this role for instance for the purposes of qualification of off-shore HFs as eligible assets for FOHFs' investments (so that it would not be necessary to bring on-shore the typical off-shore fund manager, provided that the investment adviser was subject to supervision in an OECD jurisdiction). The final wording of the Circular is less precise in this regard (unlike previous drafts), although it does recognise the role of investment advisors, which shall be disclosed in the fund's prospectus.

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