

10/3

Financial Services Authority

Funds of Alternative Investment Funds (FAIFs)

Including feedback on CP08/4

February 2010

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This Policy statement reports on responses to Consultation Paper 08/4: *Funds of Alternative Investment Funds (FAIFs) Feedback on CP07/6 and further consultation* (February 2008) and published final rules.

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1 Overview

- 1.1 In 2005 we published a Discussion Paper (DP05/3) where we examined the rapidly changing world of retail investments and risks, and whether our existing regime gave the appropriate degree of consumer protection as envisaged in the Financial Services and Markets Act 2000 (FSMA).
- 1.2 Feedback from this DP was published in 2006 (Feedback Statement 06/3) and this was followed up in March 2007 (Consultation Paper 07/6). This concerned the introduction of retail Funds of Alternative Investment Funds (FAIFs).
- 1.3 In February 2008 we published CP08/4 which contained feedback on CP07/6 and consulted on three further key issues:
 - master/feeder structures;
 - repayment standards; and
 - strengthened due diligence guidance.
- 1.4 We also consulted on proposals to introduce ‘genuine diversity of ownership’ conditions to our rules, whereby the FAIF manager would have to ensure that unit holders satisfied minimum conditions concerning investment, number and diversification.
- 1.5 The consultation period for CP08/4 closed on 22 May 2008 and respondents are listed in Annex 2.
- 1.6 In this paper we summarise the comments we received on CP08/4 and explain the changes we have made to our policy and proposed rules.
- 1.7 The aim and essence of the rules remains the same as our Consultation Paper. However, as the drafted NURS rules were too complex, we have created a separate section (COLL 5.7) entitled ‘Investment powers and limits for non-UCITS retail schemes operating as funds of alternative investment funds’.
- 1.8 Respondents welcomed our approach to introducing wider powers to NURS and our approach to due diligence.
- 1.9 They also supported our plan to introduce rules allowing master/feeder structures, where a FAIF is able to achieve its investment objectives by investing in a single collective investment scheme (CIS).

- 1.10 Following comments on our approach to unit redemptions and respondents' perceived inflexibility of our existing rules, we have reviewed our policy on repayment standards for schemes operating as FAIFs.
- 1.11 Respondents criticised our proposal to maintain the combined 20% limit on investing in unregulated schemes and unapproved securities. We recognise that this is inconsistent with our overall aim of increased flexibility for FAIFs, so we have removed this proposal while retaining the 20% limit on unapproved securities.
- 1.12 Since CP08/4 was published, the Madoff fraud has been uncovered and the global financial markets have gone through considerable turmoil. In order to protect investors through our proposals, we have included independent custody and valuation requirements that must be met if a FAIF wishes to invest in an unregulated scheme.
- 1.13 As FAIFs will be available to retail customers, they must be marketed and distributed appropriately. Therefore, we have included a factsheet that provides firms (e.g. independent financial advisors) with points they should consider when distributing a FAIF. This can be found in Annex 1.
- 1.14 Since the consultation we have assisted HM Treasury and HM Revenue & Customs with their work developing appropriate taxation regulations for authorised investment funds. Several new regulations will come into force on 6 March 2010, including some that are specifically relevant to funds which invest in non-reporting offshore funds. These are likely to be included in the underlying investments of some FAIFs.
- 1.15 We will undertake a post-implementation review of our FAIF rules, which will include how they are marketed and distributed. The exact timing of this review will depend upon the number and variety of FAIFs launched.
- 1.16 As currently drafted, the EU's Alternative Investment Fund Managers Directive (AIFMD), which will introduce new regulations affecting the operators of all collective investment schemes, will capture NURS within its scope. As a result we cannot rule out the possibility that the FAIF rules will need to be amended in future. Nevertheless, at this stage we believe it is worth proceeding with our proposals.

Structure of this paper

- 1.17 Chapter 2 sets out a summary of the feedback we received following CP08/4 and our responses, together with revisions we have made to the rules and guidance.
- 1.18 Chapter 3 sets out further issues that are relevant to FAIFs.
- 1.19 Annex 1 contains our factsheet for firms distributing FAIFs.
- 1.20 Annex 2 lists the non-confidential respondents to CP08/4.
- 1.21 Appendix 1 contains the instrument made by our Board.

Who should read this Policy Statement?

- 1.22 This statement is of interest to investment managers, consumers (and any groups representing them), potential FAIF distributors, relevant trade associations, commentators and analysts.

Background

- 1.23 In February 2008 we published our second Consultation Paper (CP07/6) on the introduction of rules enabling retail Funds of Alternative Investment Funds (FAIFs). This gave feedback following our first consultation on this subject in 2007. CP07/6 followed the 2005 Discussion Paper, '*Wider-range retail investment products: Consumer protection in a rapidly changing world*' (DP05/3). This DP explored the rapidly changing landscape of retail investments. It examined how best to strike the balance between ensuring consumers have access to an appropriate range of investment products, while securing the appropriate degree of consumer protection as envisaged by FSMA.
- 1.24 These reviews were carried out after developments in the CIS industry put stress on existing regulatory arrangements in a period of rapid change. Developments included:
- the availability of wider-range investment products to retail investors;
 - the ability of UCITS schemes to make use of 'hedge fund style' investment techniques; and
 - growing interest by international regulatory authorities in hedge funds.
- 1.25 We assessed whether the current arrangements allowed us to meet our statutory objectives of consumer protection, public understanding and market confidence. This was achieved by examining the risks the rules were intended to mitigate, and whether a more high level, principles-based approach could achieve a better outcome in terms of our statutory objectives. We concluded that the time was right to consult on extending the range of investment products available in the retail market.
- 1.26 The new rules and guidance will come into force on 6 March 2010.

2 Feedback on CP08/4

Introduction

- 2.1 CP08/4 asked five questions. In this chapter we summarise the responses received, our observations and, where relevant, any changes we have made to our proposals.
- 2.2 This chapter is split into three parts: the first details the specific responses to the questions and our comments on them; the second is a summary of other comments made by respondents; and the third details other changes we have made to the rules consulted upon.
- 2.3 We received responses to our proposals from 20 organisations and we are grateful to all of those who took the time to submit their comments. The comments that follow are taken from the responses we received but are not individually attributed.
- 2.4 A list of respondents can be found in Annex 2.

Part one – specific responses to CP questions and our comments

Repayment standards

- 2.5 As a result of the responses to CP07/6, where we proposed to leave the current repayment standards (where payment for a redeemed unit is made within four business days following the execution of the deal – known as T+4) as they are, we asked the following questions:
 - Q1:
 - (a) Do we need to make any changes to the NURS repayment standards?
 - (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?
- 2.6 There was an overwhelming response that the current repayment standards (e.g. limited ability to use cut-off points, notice periods and T+4 repayment requirements) would make administering FAIFs almost impossible, severely

limiting the availability of these products. Some respondents said they could not operate FAIFs if the current rules concerning unit dealing and fund valuation were not changed.

- 2.7 Here is a summary of respondents' suggestions on how to change the repayment standards, which may enable FAIFs to operate:
- The scheme's net asset value (NAV) needs to be calculated up to one month after the valuation point. This gives firms time to gather up-to-date valuations from unregulated schemes that either value infrequently or have delays in collecting valuation information (e.g. funds of hedge funds).
 - FAIF managers need to be able to pay unit holders up to one month after the NAV has been calculated. This gives firms time to sell any of the FAIF's underlying assets, which may be less liquid than traditional securities (e.g. collective investment schemes operating with limited redemption).
 - There needs to be greater flexibility in using cut-off points and introducing notification periods. This will help manage liquidity.
- 2.8 All respondents agreed that deviation from current standards, as applied to authorised schemes, needed to be fully detailed, along with their impact on unit holders, in the scheme documentation.
- 2.9 Respondents felt that any amendments stemming from this consultation should be available to all schemes that operated a limited redemption policy. It should not be exclusive to FAIFs.

Our response: It is clear that our proposed FAIFs model will only work if there are considerable changes in how unit deals are carried out, particularly when redemption proceeds are calculated and paid for.

However any changes to the rules, and as a result any payment standards adopted by a firm, must be in the best interests of unit holders.

With these points in mind, we have amended the following sections: COLL 6.2 and 6.3. FAIFs now have greater flexibility in the time allowed to calculate NAV and to pay redemption proceeds.

Under the current rules, the authorised fund manager must pay the unit holder the proceeds of redemption. This must take place within four business days after the day the unit price is calculated.

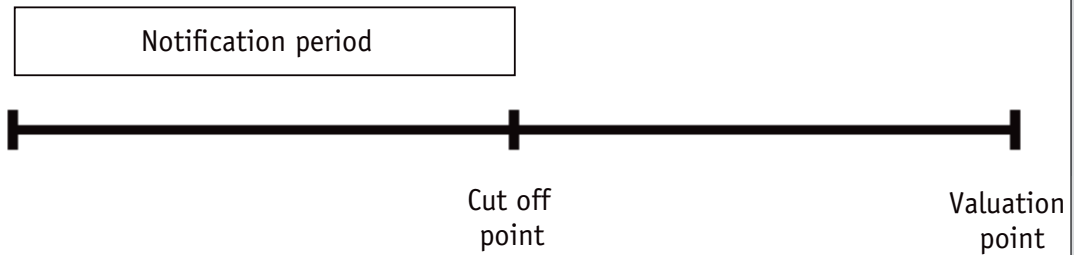
However, the problem with the fixed four day period is that more illiquid assets cannot be sold in time to cover the redemption. Therefore, we have added a provision to COLL 6.2.16R. This allows authorised fund managers who operate FAIFs to pay redemptions up to 185 days from the receipt and acceptance of the instruction.

We have also amended COLL 6.2.19R to include FAIF structures in the qualifying criteria for limited redemption. We have excluded FAIFs from the requirement, in COLL 6.3.4R(6), that higher volatility funds must have at least one valuation point every business day.

We believe authorised fund managers will now be able to operate FAIFs with the required flexibility to determine NAV and payment of redemptions within a 185 day period. Under the new rules the following processes are allowed:

- Notification period: FAIF managers can define periods where redemption instructions are received and accepted for specific valuation points. This can be combined with a cut-off point which gives managers enough time to determine the liquidity requirements of a scheme. For example:

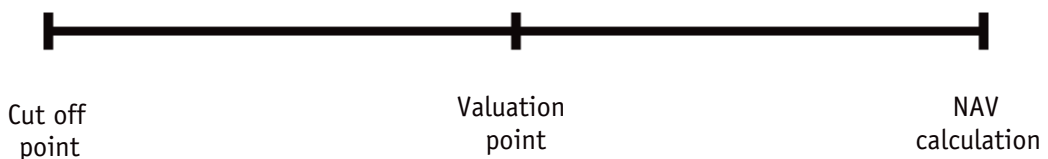
Figure 1



In this example, for a monthly dealing fund, the notification period is one calendar month with the cut-off point the close of business on the last business day of that month. The valuation point is the close of business on the last business day of the following month. Although the eventual NAV will be as at the same date as the valuation point, it is not calculated now.

- Calculating the NAV: Under the existing rules, where an authorised fund operates limited redemption arrangements, the authorised fund manager can decide when it will determine the price it will sell or redeem units, as long as this is done within 185 days of the date of the receipt and acceptance of these instructions. This is outlined in COLL 6.2.16R(7). Therefore, a FAIF's NAV can be calculated at some point after the stated valuation point, as follows:

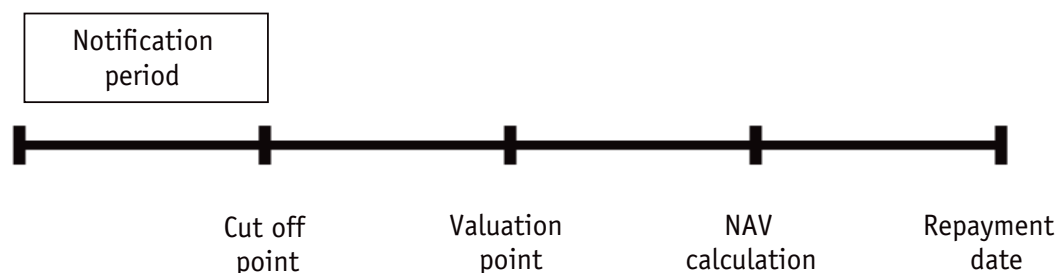
Figure 2



As with figure 1, the NAV calculation occurs on the final business day of the month.

- Redemption repayment: The new rules will allow a FAIF manager to pay unit holders their redemption proceeds up to 185 days following the receipt and acceptance of the instruction to redeem. Therefore, following the previous examples, payment could be made on the last business day of month four:

Figure 3



The overall period used in this example is four months or approximately 122 days. This is well within the maximum period of 185 days from the beginning of the notification period. Funds operating limited redemption arrangements have to publish a valuation each month, which will be of interest to investors who are in the process of redeeming units.

At present, this flexibility is only being implemented for FAIFs. However, we will consider extending it to other types of NURS as part of our post-implementation review.

Details of how units in the scheme are redeemed must be disclosed in the scheme's documentation so the unit holder fully understands the redemption arrangements, and the maximum period between the request to redeem units and payment of redemption proceeds. We have not provided specific rules or guidance on the scheme documentation's contents. This is because COLL 3 and 4 already require sufficient details concerning the valuation and pricing of scheme property and unit dealing.

Master/feeder structures

2.10 In CP08/4 we agreed that master/feeder structures could be used and discussed how they may be implemented. In proposing our preferred solution we stated that it would:

“...include a requirement within our rules that where a NURS is a feeder fund, the manager must ensure that its master and any scheme into which the master scheme invests, operates on a basis that is consistent with the rules relating to NURS in COLL chapter 5.6. The guidance makes it clear that the failure of the master fund to do so remains the responsibility of the manager of the feeder fund, notwithstanding any due diligence carried out.”

2.11 We invited responses with the following question:

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.

2.12 Respondents supported FAIF's ability to engage in a master/feeder structure; however there were comments on our approach.

- 2.13 Respondents objected to our proposal to make underlying funds in the master structure subject to the restrictions imposed on NURS. They said that by imposing these restrictions, master/feeder structures could not operate with the freedom that FAIFs investing directly in unregulated funds do. Respondents felt that due diligence is sufficient and that no additional restrictions are necessary.
- 2.14 We were asked to clarify which of the underlying investments (either the master scheme or the underlying schemes) were to be identified as “second schemes” under the proposed rules.
- 2.15 Several respondents also objected to the feeder being held liable for the failures of the master.

Our response: We acknowledge that applying NURS rules to schemes held by a master scheme would restrict operating the FAIF, which would not be present, were it to invest directly in those schemes.

However, where a master/feeder structure is employed to achieve the FAIF’s objectives, we believe the master scheme is a substitute for the feeder scheme. It must therefore abide by the rules applicable to the feeder scheme. Master schemes cannot be used to circumvent the restrictions placed on FAIFs.

It is the feeder’s authorised fund manager’s responsibility to monitor the master scheme closely and ensure it abides by the COLL rules. In the event of a failure, the feeder scheme’s authorised fund manager may be liable.

Consequently we have removed references to schemes held by the master scheme, but have kept the rule that places responsibility on the FAIF’s authorised fund manager to ensure that the master scheme operates consistently with COLL 5.7’s requirements. This approach is needed to prevent the either deliberate or accidental circumvention of rules intended to safeguard consumers.

As a result, second schemes identified by the rules are:

Figure 4: Direct investments in second schemes (S.Scsm 1, etc.) made by a FAIF (this example concentrates on three unregulated schemes)

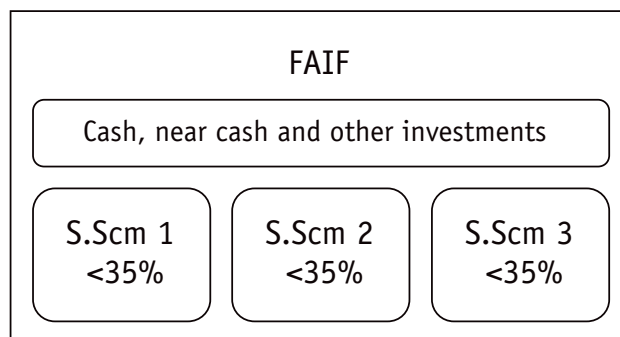


Figure 5: Investment in unregulated schemes made via a master fund

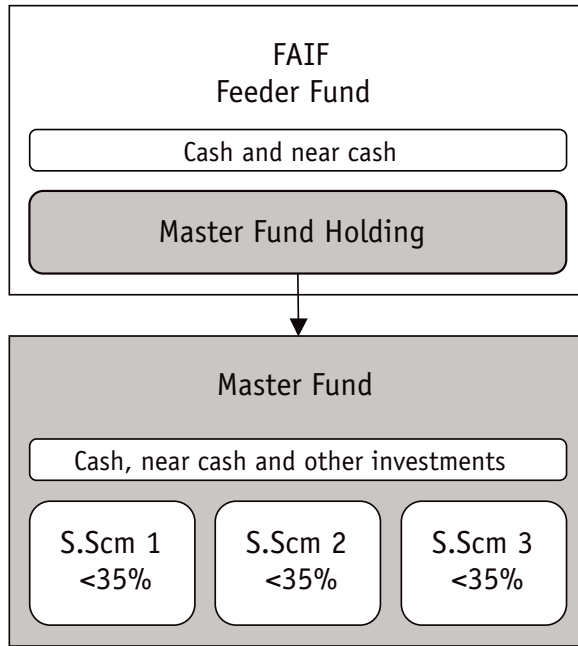
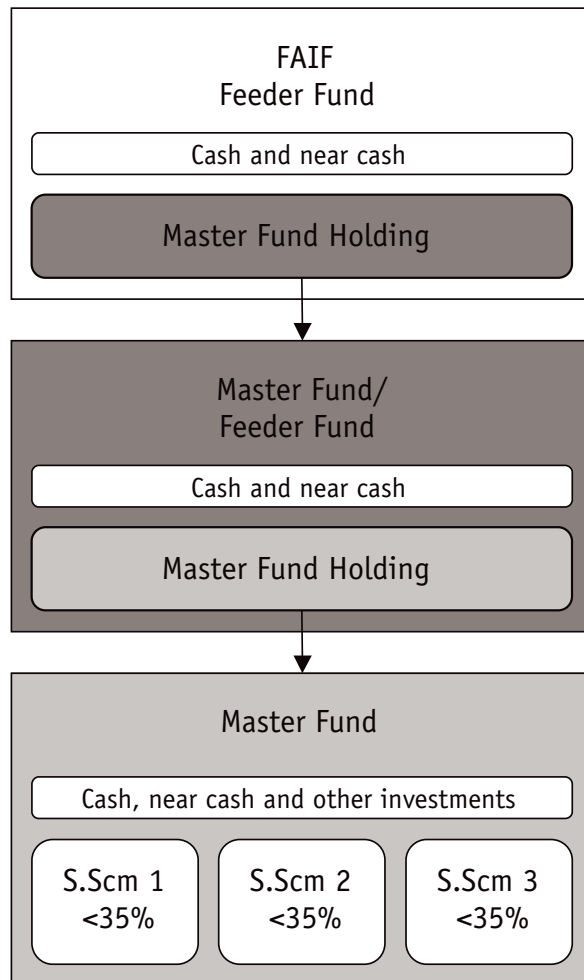


Figure 6: Investment made via a master fund which itself is a feeder fund



Due diligence approach

- 2.16 In CP08/4 we proposed a strengthened approach to due diligence, compared to that considered in CP07/6.
- Q3: What are your views on the proposed strengthened due diligence? Are there any other matters that need to be taken into consideration?
- 2.17 Respondents agreed with the concept of due diligence and the majority agreed with our proposals to strengthen requirements following our consultation in CP07/6.
- 2.18 Our rules are also consistent with The International Organization of Securities Commissions' (IOSCO) *'Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices'*, published in September 2009.
- 2.19 However several respondents were concerned that imposing higher levels of due diligence could curtail the authorised fund manager's ability to make investment decisions.
- 2.20 There were also concerns that including due diligence guidance could be used as a box-ticking exercise by authorised fund managers in an attempt to demonstrate compliance with the rules.
- 2.21 Some respondents suggested that we set definitive industry standards, while others suggested that no standards should be set and that authorised fund managers should be free to choose the due diligence requirements that best suit a scheme's underlying investments.
- 2.22 We were also asked what, if any, additional requirements would be placed on depositaries¹ after due diligence has been introduced.

Our response: Recent events in the international fund industry have shown the importance of thorough and accurate due diligence.

In our opinion, the factors set out in our due diligence guidance are relevant to investing in underlying unregulated schemes.² FAIFs, despite their wider investment powers, are still retail schemes into which the public can invest with little or no advice. These investors rely on the authorised fund manager to know and understand the risks associated with the investments which comprise the FAIF. As a result, if an authorised fund manager can not obtain sufficient information on a target investment to satisfy our requirements, the manager should not invest in it.

Consequently, we have kept our more detailed due diligence requirements. We have also strengthened requirements concerning the custody and valuation of underlying schemes as follows.

1 The depositary (trustee for an authorised unit trust) is responsible for the safekeeping of an authorised scheme's assets and the oversight of the authorised fund manager.

2 Where relevant, managers may also wish to consult additional sources of good practice, such as the IOSCO Standards.

Custody

The FAIF manager will be required, when investing in an underlying scheme, to carry out initial and ongoing due diligence to determine that the property of that scheme is held by a third party independent of the underlying scheme's manager. Although we understand this may limit the eligibility of some underlying schemes in the short term,³ we believe this is important in order to protect investors.

Valuation

We originally proposed that the FAIF manager should, when carrying out due diligence, consider the valuation processes of an underlying scheme, including how much independence is involved. However, requiring complete independent third party valuation would not be consistent with existing rules for authorised schemes. Even when there is an independent valuation provider, the fund manager often feeds into the valuation process, in particular for illiquid or hard-to-value assets where the fund manager may be best placed to provide an accurate price.

Although we are keeping the due diligence measures concerning valuation, the FAIF manager must now carry out initial and ongoing due diligence to ensure that the calculation of an underlying scheme's NAV and the maintenance of its accounting records, are segregated from the scheme's investment management function.

As already required by COLL 6.6.4R, the depositary must take reasonable care to ensure the authorised fund manager complies with COLL 5. To do so, the depositary must take reasonable care to ensure a due diligence process is in place and being operated. It should also be at least as detailed as the requirements given in COLL 5.7.

Genuine diversity of ownership

Q4: Do you have any comments on this proposal?

- 2.23 Respondents found the principles discussed in CP08/4 acceptable. However, some believed COLL should not include detailed rules, as the proposed requirements concerned taxation matters.
- 2.24 Since CP08/4, the UK government has taken steps to address the taxation issues concerning authorised investment funds, which prompted our proposed rules. These include the recently published tax regulations for funds investing in non-reporting funds (SI 2010/294), which come into force on 6 March 2010. Following the legislation, we have agreed with HM Treasury and HM Revenue and Customs that genuine diversity of ownership requirements concerning FAIFs are no longer needed in our Handbook.

³ In July 2009, the Hedge Fund Standards Board published a consultation in which they proposed that managers should encourage hedge funds' governing bodies to appoint an independent third party to carry out fund custody. The current draft of the EU Alternative Investment Fund Managers Directive envisages independent custody of the assets of funds subject to its requirements.

- 2.25 However, we have included a provision in our guidance to the contents of the scheme prospectus. This notes that additional content requirements outside COLL 4.2.5R may be relevant, for example, under any relevant tax legislation which may affect an authorised scheme.

Cost Benefit Analysis (CBA)

- 2.26 In CP08/4 we discussed the impact of our proposals concerning master/feeder structures, due diligence and diversity of ownership. We also discussed any possible direct costs to the FSA. We summarised these issues with this question:

Q5: Do you have any comments on the CBA?

- 2.27 Respondents raised no comments to the CBA as consulted on in the paper.
- 2.28 However, we have introduced additional requirements about the custody arrangements and valuation of second schemes. We believe these new requirements will not affect the costs firms are likely to incur when conducting due diligence, as discussed in the original CBA, and protect unit holders further.
- 2.29 After the responses we received during the consultation, we have made changes to repayment standards. These aim at making repayment standards workable for the industry and at giving investors adequate protection.
- 2.30 Firms that adopt the wider powers available to enable the operation of a FAIF may – on top of costs discussed in CP08/4 – incur one-off development costs in updating systems and processes tailored to the dealing and repayment frequency appropriate for the scheme.
- 2.31 We have attempted to calculate these costs through discussions with relevant stakeholders. The feedback we have received is that developing systems capable of dealing and repayment frequencies of up to 185 days are estimated to be in the region of £500,000. However the exact cost will depend on the level of development needed and will vary from firm to firm. Additional costs may be incurred depending on other systems developments which may be required by the FAIF operator. However, due to the unknown nature of these developments, stakeholders were unable to indicate the level of these costs. We expect the costs of these system developments to be borne by the firms involved in their development and not the resulting FAIFs.
- 2.32 In addition to development costs, variations to ongoing charges such as registrars' fees may depend on how many unit holders are affected. These costs may be borne by the FAIF and, consequently, the unit holders.
- 2.33 Firms need to factor these costs into their decisions as to whether they will establish a FAIF. These costs may therefore lead some firms to decide not to enter the FAIF market.

Part two – other comments made by respondents

- 2.34 In addition to responses received for specific questions we asked in CP08/4, we received other comments, which fell into the following categories:

Leverage

- 2.35 NURS are limited to directly borrowing 10% of NAV, although a NURS investing in property may indirectly borrow up to 20% through exposure to mortgages. We proposed to leave this unchanged for FAIFs. Respondents – particularly hedge fund managers – argued that increased leverage limits were necessary to manage fund liquidity.

Our response: Despite this, we believe the 10% limit is appropriate; FAIFs are intended to provide increased product choice for the average retail consumer. High borrowing levels can result in increased risk and may not be appropriate for retail products, so standard NURS leverage rules will apply. If a firm wishes to use higher leverage, it can launch a Qualified Investor Scheme (QIS) instead; however this type of scheme cannot be marketed to retail investors.

Commodities

- 2.36 Several respondents asked us to consider extending NURS rules to investing in commodities. NURS can currently hold up to 10% of the scheme's property in gold. Respondents argued there is no rationale for gold to be the only commodity allowed and that other precious metals, such as silver and platinum, should also be permitted.

Our response: Although we acknowledge that the rules relating to commodity exposure can be reviewed, we have not done so at this time.

Unapproved securities

- 2.37 Respondents again questioned our decision to maintain the current 20% limit on a FAIF's exposure to unapproved securities against its exposure to unregulated CIS.
- 2.38 Our original proposals would have reduced a FAIF's ability to hold unapproved securities as the exposure to unregulated CIS increased – as is currently the case with NURS – from 20% of the FAIF's NAV to zero. Respondents argued that reducing a FAIF's exposure to unapproved securities due to liquidity management (as stated in CP08/4) was illogical, as these securities would generally be more liquid than the unregulated CIS, which most FAIFs would be exposed to.

Our response: After considering all responses, together with our aim of creating a simple but effective regime for FAIFs, we have concluded that the aggregation proposals imposed overly complex requirements, which may not have resulted in the benefits we originally envisaged. We have therefore removed this requirement for FAIFs, although it remains for NURS in general.

Part three – further amendments to the rules

- 2.39 We have also amended the following rules where we think it would benefit the operation of the FAIF regime. These changes do not alter the meaning or intention of the rules already consulted on.

Structure

- 2.40 To date, the consultation process (concerning FAIFs based on NURS) has included draft rules that incorporate the FAIFs regime within the existing NURS rules section. However, this has caused an overly complex outcome. So, we have created a new section, 'COLL 5.7 – Non-UCITS retail schemes operating as funds of alternative investment funds', which only deals with investment restrictions that are applicable to NURS operating as FAIFs. This will help authorised fund managers and depositaries to clearly see which regulatory requirements are applicable to standard NURS products and which are applicable to FAIFs.

Qualified Investor Schemes

- 2.41 The original proposals for qualified investor schemes (QIS) operating as FAIFs would have resulted in the unintended consequence of imposing new restrictions on all QIS.
- 2.42 QIS can currently operate as master/feeder structures and can invest up to 100% of their assets in unregulated schemes. When we proposed to apply rules for master/feeder structures which mirrored those applicable to NURS, we would have placed restrictions on QIS master/feeder structures, which currently do not exist.
- 2.43 As a result, we have dropped proposals to impose requirements on the authorised fund manager of the feeder scheme to ensure the master scheme operates as a QIS. However, we have kept our new requirement that managers must carry out due diligence where more than 20% of the QIS assets are invested in unregulated schemes.

Property authorised investment funds (PAIFs)

- 2.44 CP08/4 said that some fund structures, which involved an insurer wanting to invest in a Property Authorised Investment Fund, might need a master/feeder structure to operate for taxation reasons. Although this would now be achievable under the FAIF master/feeder rules (the PAIF feeder would be a FAIF), because the fund to which it would be dedicated (the PAIF) is by definition a NURS, it would be needlessly costly to impose the FAIF master/feeder requirements in this case.
- 2.45 So, we have added rules to COLL 5.6.7R allowing PAIF feeders to operate within the existing NURS regime.

3 Other issues relevant to FAIFs

Authorisation process

- 3.1 We plan to carry out the FAIFs authorisation process as an extension of the current NURS process. We may ask management companies to provide additional information, which may focus on any due diligence procedures, processes and resources in place, as required by COLL. We will also ask the management company if they have demonstrated how suitable their processes are with the scheme's depositary. When considering an application, the firm's FSA supervision team may be asked if they believe an applicant can carry out the claimed level of due diligence.

Investor Protection

- 3.2 Recent events in the investment industry since our last consultation, especially in relation to the Madoff fraud, have caused us to review our proposals. Although outright fraud cannot always be prevented, we believe there are several key elements in our proposed FAIF regime that would mitigate the major failings that emerged in the Madoff fraud, including serious structural and operational conflicts of interest.
- 3.3 As discussed in this paper there are, among the regulatory elements of the FAIFs regime, requirements for due diligence to be carried out by the FAIF manager. These include verifying that valuation has been independently overseen, and there is independent custody of the underlying investments.
- 3.4 As well as making sure that FAIFs are managed properly, it is vital to ensure they are properly sold, thereby providing the appropriate degree of consumer protection. Intermediaries should understand how any particular FAIF they are planning to distribute operates. Our factsheet (see Annex 1) aims at helping intermediaries understand what they need to consider when distributing FAIFs.

Regulatory developments

- 3.5 There has been increasing interest in hedge fund regulation at an international and European level over the last few years. IOSCO has created principles that apply to

funds of hedge funds (FoHFs), while the European Commission has been considering, amongst other things, whether there should be a cross-border regime for non-UCITS funds. This has resulted in the proposed Alternative Investment Fund Managers Directive (AIFMD). As discussed in our consultation papers, several jurisdictions have already put retail FoHFs regimes in place. Various self-regulatory initiatives have also been initiated (e.g. the creation of the Hedge Funds Standards Board).

- 3.6 This regulatory focus has intensified during the ongoing market turbulence amidst fears that hedge funds pose a systemic risk and the question of increased regulation (and reporting) for hedge funds, has been raised. At an EU level this is also addressed in the AIFMD. We consider, however, that these developments should not deter us from putting the proposed FAIFs arrangements in place.
- 3.7 It is difficult to currently assess the actual impact of the AIFMD, as we expect significant changes to the draft Directive as negotiations continue. Based on the original drafting, the extent to which we could impose requirements in respect of NURS over and above the Directive is unclear. However, we will continue to maintain the right to do so in our negotiations with the European Commission.
- 3.8 The level of harmonisation in the AIFMD and the extent of its level 2 implementing measures could also restrict us from maintaining an effective non-UCITS retail scheme regime. This is because it includes possible additional capital requirements for operators and there is potentially the need for schemes to be re-authorised.
- 3.9 Given the level of uncertainty and our belief that other Member States will also wish to retain the ability to have national non-UCITS retail fund regimes, we hope we can to maintain our NURS regime. Therefore, we have proceeded to publish this policy statement bringing the new rules and guidance for FAIFs into force.

Policy development

- 3.10 When creating a new product regulatory regime, market developments and innovation often highlight areas where our desired policy outcomes can be achieved different from the way set out in our rules. As a matter of course we will keep the rules under review and we welcome feedback from stakeholders.
- 3.11 When a sufficient number of FAIFs have been operating for some time, we will conduct a formal post-implementation review into how the rules work. This will include a review of how and to whom FAIFs have been sold. Managers who launch FAIFs should note we may approach them to request information relevant to our post-implementation review at that time.

Factsheet for intermediaries: Funds of Alternative Investment Funds (FAIFs)

Background

The FSA has put in place rules allowing a new type of collective investment scheme to be marketed and distributed⁴ to retail investors. This is called a ‘Fund of Alternative Investment Funds’ (FAIF).

A FAIF can invest up to 100% of its assets into other collective investment schemes.⁵ The new rules allow a FAIF greater flexibility as to the proportion of its assets invested in particular types of underlying scheme. For example, a FAIF could invest up to 100% of its assets in a selection of hedge funds based in non-EU countries.

When it takes advantage of this additional flexibility, the FAIF manager must carry out initial and ongoing due diligence on the underlying schemes it is investing in.⁶

The new rules also allow ‘master/feeder’ structures. Here, the FAIF ‘feeds’ the majority of its assets into a master scheme, which in turn invests in a wider range of underlying schemes.⁷ The master scheme may be based in the UK or abroad. Where a master/feeder structure is used, the manager of the UK-authorized FAIF (the feeder) is responsible for ensuring the master scheme operates consistently with the FSA rules specifying the investment powers and borrowing limits for FAIFs.

As any underlying schemes a FAIF may invest in may have infrequent dealing periods, a FAIF may set up its redemption arrangements so that up to 185 days elapse between the acceptance of a redemption order and the payment to an investor of the redemption proceeds. The FAIF’s documentation will set out its unit/share issue and redemption arrangements.

What is the purpose and status of this factsheet?

We have designed this factsheet to help intermediaries consider what they need to do when distributing FAIFs. A wide range of FAIFs may become available and intermediaries should understand any they choose to distribute.

4 In this factsheet, we use the term ‘distributed’/ ‘distributing’ to include sales both on an advised and non-advised basis.

5 A FAIF can also invest in other assets consistent with the FSA rules for non-UCITS retail schemes.

6 The details of the due diligence can be found in the FSA Handbook, at COLL 5.7.

7 The master scheme may also invest in other assets consistent with the FSA rules for FAIFs.

The factsheet does not constitute formal FSA guidance and is not an exhaustive list of points that an intermediary should consider when distributing a FAIF. It also does not attempt to cover all general points relevant to the distribution of investment products, collective investment schemes or funds of funds more generally.

This factsheet does not amend or qualify any rules and guidance in the Handbook (and Regulatory Guides) and is not a substitute for reading the relevant provisions of the Handbook.

Firms are responsible for determining the regulatory requirements relating to their business and ensuring they comply with those requirements. We also specifically draw your attention to the 'Distributor responsibilities' section of the Regulatory Guide 'The responsibilities of providers and distributors for the fair treatment of customers'.⁸

What information will be available to intermediaries about a particular FAIF?

As with any authorised collective investment scheme, the FAIF manager must produce a full, detailed prospectus, as well as a simplified prospectus or key features document.⁹

The manager may also produce a range of marketing material, either for use only with intermediaries, or aimed directly at prospective retail investors. Both publications should be fair, clear and not misleading.¹⁰

Which principles and rules apply when my firm distributes units/shares in a particular FAIF?

The FSA's 'Principles for Businesses' set out the fundamental obligations of firms under the regulatory system. Principles 1 (integrity), 2 (skill, care and diligence), 6 (customers' interests), 7 (communications with clients), 8 (conflicts of interest) and 9 (customers: relationships of trust) are of particular relevance to the distribution of FAIFs.¹¹

Units/shares in collective investment schemes – including FAIFs – fall within the definitions of 'designated investments' and 'financial instruments', and the relevant provisions of the Conduct of Business Sourcebook (COBS) apply when they are being marketed or distributed. This includes the overarching 'client's best interests rule' (COBS 2.1.1R):

A firm must act honestly, fairly and professionally in accordance with the best interests of its client.

8 Available on our website at <http://fsahandbook.info/FSA/html/handbook/RPPD/link/PDF>.

9 Under COBS 14.2, the simplified prospectus or key features document must generally be provided to the investor.

10 In 'The Responsibilities of Providers and Distributors for the Fair Treatment of Customers' we said that a product provider ought to consider whether "...information is sufficient, appropriate and comprehensible in substance and form, including considering whether it will enable distributors to understand it enough to give suitable advice (where advice is given) and to extract any relevant information and communicate it to the end customer. As part of meeting this standard, the provider may wish to consider, with regard to each distribution channel or type of distributor, what information distributors of that type already have, their likely level of knowledge and understanding, their information needs and what form or medium would best meet those needs (which could include discussions, written material or training as appropriate)."

11 The text of the Principles is available on our website at <http://fsahandbook.info/FSA/html/handbook/PRIN/2/1>.

COBS 9 ('Suitability') and COBS 10 ('Appropriateness') are some of the relevant rules that may apply when your firm is distributing a FAIF. Which chapter is relevant depends upon whether your firm is making a 'personal recommendation'¹² – in which case COBS 9 will apply – or not, in which case COBS 10 may apply.¹³

Under COBS 9, an assessment of suitability involves the firm in gathering the necessary relevant information from the customer in order to be satisfied that investing in the FAIF meets the customer's investment objectives (including attitude to risk), that they can bear financially any risks related to those objectives, and that they have the experience and knowledge to understand the risks involved in investing in the FAIF.

Under COBS 10, for 'non-advised' transactions, an assessment of appropriateness involves the firm requesting information from the customer which would enable it to assess whether investing in the FAIF would be appropriate for the customer. The firm must assess whether the customer has the necessary experience/knowledge to understand the risks involved in investing in the FAIF.

Under certain conditions (set out in COBS 10.4), a financial instrument which is 'non-complex' can be sold without the firm needing to carry out an appropriateness assessment. To be considered non-complex, one of the criteria that have to be met is that 'there are frequent opportunities to dispose of, redeem, or otherwise realise the instrument...' As mentioned earlier, certain FAIFs may have infrequent unit/share redemption, and so would not be eligible to be treated as non-complex. The decision whether a FAIF can be categorised as non-complex will therefore need to be taken by an intermediary before deciding that it can be sold without the need for an appropriateness assessment.¹⁴

The FSA has published further information about some of the requirements mentioned above, in addition to the material in the Handbook itself. For example, we have published Q&As and case study examples on key COBS requirements on our COBS webpages.¹⁵

As with any regulated business, a failure to follow the rules applying to the particular type of transaction could leave your firm open to complaints and/or regulatory action.

What points are relevant for intermediaries to consider when distributing units/shares in FAIFs?

We set out below some relevant considerations for intermediaries that focus on aspects particularly relevant to FAIFs. In general, for all these points, intermediaries should consider not only their own understanding of the issue concerned, but also

12 Or when providing discretionary portfolio management services.

13 If you are a non-MiFID firm, COBS 10 will apply only in limited circumstances.

14 The other conditions at COBS 10.4.1R will also need to be met before an appropriateness assessment need not be carried out.

15 Available on our website at <http://www.fsa.gov.uk/Pages/Doing/Regulated/newcob/index.shtml>.

how they can explain it to their client in an appropriate manner. An intermediary should not distribute a product if they do not understand it sufficiently.

As mentioned above, our new rules require the FAIF manager to carry out due diligence on the underlying schemes it proposes to invest in. We do not expect intermediaries to repeat this due diligence themselves, but we would expect an intermediary to understand a FAIF they plan to distribute.

Intermediaries should also understand how a FAIF may differ from other investments or collective investment schemes with which they are already familiar.

The key document for an intermediary to consider will be the FAIF's prospectus. Having read this, can you answer the following questions, where relevant?

General points

- Do I understand the material in the prospectus? Can I explain the FAIF to a client in a way they would understand?
- Does the prospectus contain sufficient information to enable me to understand the FAIF, the underlying assets into which the FAIF will invest and its inherent risks?
- If I have further questions, do I have a means to get answers to these? Are the answers provided clear and consistent with my understanding of the FAIF?

Investment issues

Question	Example points to consider
Do I understand the investment objectives and policy of the FAIF?	<ul style="list-style-type: none"> • What (type of) underlying schemes will the FAIF invest in? • What due diligence processes has the FAIF manager put in place to select and monitor the underlying schemes into which the FAIF will invest? • What other assets will the FAIF invest in? • Are the risks of the FAIF's investments made clear? • How narrowly is the FAIF manager constrained in his choice of underlying investments? • What is the scope for change in the underlying investments without informing or seeking the consent of unit/shareholders? • Will the FAIF use borrowing? • Do the past reported returns of the FAIF appear consistent with its underlying investments and risk profile?

Question	Example points to consider
Am I comfortable that I have enough information about the (types of) underlying schemes that the FAIF will invest in?	<ul style="list-style-type: none"> • Where are the underlying schemes established, what is their legal structure and what regulation are they subject to in that territory? • Are the underlying schemes managed by the same company as, or a company connected to, the FAIF manager? • How diversified is the FAIF likely to be, based on its investment policy? • How is the FAIF likely to perform in different market conditions? • Is there more information about the underlying schemes available?
Is the FAIF a feeder into a master scheme	<ul style="list-style-type: none"> • If so, why is this structure being used? • Is the master scheme also managed by the manager of the feeder FAIF? • Is the master scheme authorised by the FSA? If not, what regulatory requirements apply to the master in the jurisdiction in which it is based? • How does the FAIF manager propose to monitor whether the master scheme operates consistently with FSA rules specifying the investment powers and borrowing limits for FAIFs?

Operation of the FAIF

Question	Example points to consider
Do I understand the redemption and dealing policy of the FAIF?	<ul style="list-style-type: none"> • How frequently can investors redeem their units/shares? • What are the key dates by which they need to inform the FAIF manager of their notice to redeem? • How is the calculation of their redemption proceeds carried out and when will they receive them?
Are the charges involved in the FAIF clear?	<ul style="list-style-type: none"> • Are there multiple layers of charges for the FAIF, reflecting its nature as a fund of funds? • How do the charges impact on the FAIF's performance? • Does the FAIF charge a performance fee? • How do charges apply where the FAIF is a feeder into a master scheme? • How do charges apply if a master scheme or underlying scheme is managed by the same company that manages the FAIF?

Other issues

- Is any marketing material I am going to use with investors (either provided by the FAIF manager, a third party or self-created) clear, fair and not misleading? Is it consistent with material in the prospectus?
- Do I understand how the FAIF will be taxed, and what the taxation implications and responsibilities are for a client who invests in the FAIF?

List of non confidential respondents to CP08/4

Association of Independent Financial Advisers (AIFA)

Alternative Investment Management Association (AIMA)

AVIVA Plc

Barclays Wealth

BlackRock Investment Management (UK) Ltd

Campion Capital Ltd

Centre for Financial Market Integrity (CFA)

Depository and Trustee Association (DATA)

Dechert LLP

Fidelity Investments International

The Financial Services Consumer Panel

HSBC

Investment Management Association (IMA)

JP Morgan Asset Management

KPMG

Lipper

M&G

Schroders Investment Management Ltd

Scottish Widows

St James's Place Wealth Management

Funds of alternative investment funds instrument 2010

FUNDS OF ALTERNATIVE INVESTMENT FUNDS INSTRUMENT 2010

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the powers and related provisions in or under:
- (1) the following sections of the Financial Services and Markets Act 2000 (“the Act”):
 - (a) section 138 (General rule-making power);
 - (b) section 156 (General supplementary powers);
 - (c) section 157(1) (Guidance);
 - (d) section 247 (Trust scheme rules); and
 - (e) section 248 (Scheme particulars rules); and
 - (2) regulation 6(1) (FSA rules) of the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228); and
 - (3) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.
- B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 6 March 2010.

Amendments to the Handbook

- D. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Collective Investment Schemes sourcebook (COLL) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Funds of Alternative Investment Funds Instrument 2010.

By order of the Board
25 February 2010

Annex A**Amendments to the Glossary of definitions**

Insert the following new definitions in the appropriate alphabetical position.

FAIF *fund of alternative investment funds.*

fund of alternative investment funds *an authorised fund whose instrument constituting the scheme contains the statement in COLL 3.2.6R(7C) (Table: contents of the instrument constituting the scheme) that it is a fund of alternative investment funds.*

Annex B

Amendments to the Collective Investment Schemes sourcebook (COLL)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Types of authorised fund

- 1.2.1 R An application for an *authorisation order* must propose that the *scheme* be one of the following types:

...

- (2) a *non-UCITS retail scheme* including a *non-UCITS retail scheme* operating as a *fund of alternative investment funds (FAIF)*; or

...

Types of authorised fund - explanation

- 1.2.2 G ...

- (2) *Non-UCITS retail schemes* are *schemes* that do not comply with all the conditions set out in the *UCITS Directive*. Such *schemes* could become *UCITS schemes* provided they are changed, so as to comply with the conditions set out in the *UCITS Directive*. *Non-UCITS retail schemes* operating as *FAIFs* have wider powers to invest in *collective investment schemes* than other *non-UCITS retail schemes*.

...

...

Table: contents of the instrument constituting the scheme

- 3.2.6 R ...

...	
	<u>Funds of alternative investment funds</u>
<u>7C</u>	<u>For a <i>non-UCITS retail scheme</i> operating as a <i>FAIF</i>, a statement that it is a <i>fund of alternative investment funds</i>.</u>
...	

...

Table: contents of the prospectus

4.2.5 R ...

...	
Investment objectives and policy	
3	The following particulars of the investment objectives and policy of the <i>authorised fund</i> :
	...
	(k) ...
	(ka) <u>where a <i>scheme</i> is a feeder <i>scheme</i>, which (in respect of investment in <i>units</i> in <i>collective investment schemes</i>) is dedicated to <i>units</i> in a single <i>collective investment scheme</i>, details of the master <i>scheme</i> and the minimum (and, if relevant, maximum) investment that the feeder <i>scheme</i> may make in it;</u>
	...
...	
<u>Funds of alternative investment funds</u>	
<u>22B</u>	<u>For a <i>non-UCITS retail scheme</i> operating as a <i>FAIF</i>, a statement that it is a <i>fund of alternative investment funds</i>.</u>
...	

...

4.2.6 G ...

- (5) Additional matters which are not contained in COLL 4.2.5R may be required to be included in the *prospectus*, for example for the purposes of making the *scheme* eligible under relevant tax legislation.

...

Application

5.1.1 R ...

- (2) Subject to 2(A), COLL 5.1, COLL 5.4 and COLL 5.6 apply to the *authorised fund manager* and *depository* of an *authorised fund*, and

to an *ICVC*, which is a *non-UCITS retail scheme*.

(2A) *COLL 5.1, COLL 5.4 and COLL 5.7 apply to the authorised fund manager and the depositary of an authorised fund and to an ICVC which is a non-UCITS retail scheme operating as a fund of alternative investment funds.*

(3) ~~Paragraph~~ Paragraphs (2) and (2A) ceases to apply if a *non-UCITS retail scheme* converts to be authorised as a *UCITS scheme*.

...

Indicative overview of investment and borrowing powers

5.1.4 G This table belongs to *COLL 5.1.2G(2)*.

<i>Scheme investments and investment techniques</i>	<i>Limits for UCITS schemes</i>		<i>Limits for non-UCITS retail schemes</i>	
	<i>Permissible investment</i>	<i>Maximum limit</i>	<i>Permissible investment</i>	<i>Maximum limit</i>
...				
<i>Regulated schemes other than <u>qualified investor schemes</u></i>	Yes	None	Yes	None
<i>Unregulated schemes and <u>qualified investor schemes</u></i>	No	N/A	Yes	20% (C)
...				
Note:	Meaning of terms used:			
...				
“N/A”	...			
“(C)”	<u>In the case of a non-UCITS retail scheme operating as a FAIF there is no maximum limit – see COLL 5.7.7R.</u>			

...

Spread: general

5.6.7 R ...

(6) Except for a *feeder fund* or a *scheme dedicated to units in a single*

property authorised investment fund, not more than 35% in value of the *scheme* is to consist of the *units* of any one *scheme*.

- (6A) Schemes which (in respect of investment in *units* in *collective investment schemes*) are *dedicated to units* in a single *property authorised investment fund* must, in addition to the investment in the *property authorised investment fund*, only hold cash or near cash to maintain sufficient liquidity to enable the *scheme* to meet its commitments, such as *redemptions*. Schemes may also use techniques and instruments for the purpose of *efficient portfolio management*, where appropriate, such as forward foreign exchange transactions entered into for the purpose of reducing the effect of fluctuations in the rate of exchange between relevant currencies.

...

- (9) For the purpose of calculating the limit in (5), *OTC derivative* positions with the same counterparty may be netted provided that the netting procedures:
- (a) comply with the conditions set out in ~~Section 3~~ Part 7 (Contractual netting (Contracts for novation and other netting agreements)) of Annex III to the *Banking Consolidation Directive*; and

...

...

...

Guidance on spread: general

- 5.6.7A G (1) *COLL 5.6.7R(7) to (10)* replicate the provisions of Article 5 of the Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities, so as to enable *non-UCITS retail schemes* to benefit from the same flexibility. ~~This Recommendation may be accessed via http://europa.eu.int/eur-lex/pr/en/oj/dat/2004/1_199/1_19920040607en00240029.pdf.~~

...

Insert the following new section after COLL 5.6. The text is not underlined.

5.7 Investment powers and borrowing limits for NURS operating as FAIFs

Application

- 5.7.1 R (1) This section applies to the *authorised fund manager* and the *depository* of a *non-UCITS retail scheme* operating as a *FAIF* and to

an *ICVC* which is a *non-UCITS retail scheme* operating as a *FAIF*.

- (2) Where this section refers to:
- (a) a *rule* or *guidance* in *COLL 5.1* to *COLL 5.6*, these *rules* and *guidance*, and any *rules* and *guidance* to which they refer, must be read as if a reference to a *UCITS scheme* or *non-UCITS retail scheme* were a reference to a *non-UCITS retail scheme* operating as a *FAIF*;
 - (b) a second *scheme*, and the second *scheme* is a feeder *scheme* which (in respect of investment in *units* in *collective investment schemes*) is *dedicated* to *units* in a single *collective investment scheme*, the reference in this section to the second *scheme* must be read as if it were a reference to any *scheme* into which the feeder *scheme*'s master *scheme* invests; and
 - (c) a second *scheme*, and the second *scheme* is a master *scheme* to which (in respect of investment in *units* in *collective investment schemes*) the relevant *non-UCITS retail scheme* operating as a *FAIF* is *dedicated*, the reference in this section to the second *scheme* must be read as if it were a reference to any *scheme* into which that master *scheme* invests.

Purpose

- 5.7.2 G (1) This section contains *rules* on the types of permitted investments and any relevant limits with which *non-UCITS retail schemes* operating as *FAIFs* must comply. These *rules* allow for the relaxation of certain investment and borrowing powers from the requirements for *non-UCITS retail schemes* under *COLL 5.6*.
- (2) Some examples of the different investment and borrowing powers under the *rules* in this section for *non-UCITS retail schemes* operating as *FAIFs* are the power to:
- (a) invest up to 100% of the value of the *scheme property* in *schemes* captured by *COLL 5.7.7R*; and
 - (b) invest in a single master *scheme*.
- (3) In order to ensure adequate *unitholder* protection, the *authorised fund manager* is required to implement certain due diligence procedures in respect of investment in second *schemes*.

Applicable rules in *COLL 5.6*

- 5.7.3 R The following *rules* and *guidance* in *COLL 5.6* (Investment powers and borrowing limits for *non-UCITS retail schemes*) apply to the *authorised fund manager* and the *depository* of a *non-UCITS retail scheme* operating as a *FAIF* and to an *ICVC* which is a *non-UCITS retail scheme* operating as a

FAIF:

- (1) *COLL 5.6.3R*;
- (2) *COLL 5.6.5R* to *5.6.6R*;
- (3) *COLL 5.6.8R* to *5.6.9R*; and
- (4) *COLL 5.6.11R* to *5.6.24R*.

Investment powers: general

- 5.7.4 R (1) The *scheme property* of a *non-UCITS retail scheme* operating as a *FAIF* may, subject to the *rules* in this section, comprise any assets or *investments* to which it is *dedicated*.
- (2) For an *ICVC*, the *scheme property* may also include movable or immovable property that is necessary for the direct pursuit of the *ICVC's* business of investing in those assets or *investments*.
- (3) The *scheme property* must be invested only in accordance with the relevant provisions in this section that are applicable to that *non-UCITS retail scheme* operating as a *FAIF* and within any upper limit specified in this section.
- (4) The *instrument constituting the scheme* may restrict the investment powers of a *scheme* further than the relevant restrictions in this section.
- (5) The *scheme property* may only, except where otherwise provided in the *rules* in this section, consist of any one or more of:
- (a) *transferable securities*;
 - (b) money market instruments;
 - (c) *units* in *collective investment schemes* permitted under *COLL 5.7.7R* (Investment in collective investment schemes);
 - (d) *derivatives* and forward transactions permitted under *COLL 5.6.13R* (Permitted transactions (derivatives and forwards));
 - (e) *deposits* permitted under *COLL 5.2.26R* (Investment in deposits);
 - (f) immovables permitted under *COLL 5.6.18R* (Investment in property) to *COLL 5.6.19R* (Investment limits for immovables); and
 - (g) gold up to a limit of 10% in value of the *scheme property*.

Spread: general

- 5.7.5 R (1) This *rule* does not apply in respect of *government and public securities*.
- (2) Not more than 20% in value of the *scheme property* is to consist of *deposits* with a single body.
- (3) Not more than 10% in value of the *scheme property* is to consist of *transferable securities* or *approved money-market instruments* issued by any single body subject to *COLL 5.6.23R* (Schemes replicating an index).
- (4) The limit of 10% in (3) is raised to 25% in value of the *scheme property* in respect of *covered bonds*.
- (5) In applying (3) *certificates representing certain securities* are to be treated as equivalent to the underlying *security*.
- (6) The exposure to any one counterparty in an *OTC derivative* transaction must not exceed 10% in value of the *scheme*.
- (7) Except for a feeder *scheme* which (in respect of investment in *units* in *collective investment schemes*) is *dedicated* to the *units* of a master *scheme*, not more than 35% in value of the *scheme* is to consist of the *units* of any one *scheme*.
- (8) For the purpose of calculating the limit in (6), the exposure in respect of an *OTC derivative* may be reduced to the extent that collateral is held in respect of it if the collateral meets each of the conditions specified in (9).
- (9) The conditions referred to in (8) are that the collateral:
- (a) is marked-to-market on a daily basis and exceeds the value of the amount at risk;
 - (b) is exposed only to negligible risks (e.g. government bonds of first credit rating or cash) and is liquid;
 - (c) is held by a third party custodian not related to the provider or is legally secured from the consequences of a failure of a related party; and
 - (d) can be fully enforced by the *non-UCITS retail scheme* operating as a *FAIF* at any time.
- (10) For the purpose of calculating the limit in (6), *OTC derivative* positions with the same counterparty may be netted provided that the netting procedures:

- (a) comply with the conditions set out in Part 7 (Contractual netting (Contracts for novation and other netting agreements)) of Annex III to the *Banking Consolidation Directive*; and
 - (b) are based on legally binding agreements.
- (11) In applying this *rule*, all *derivatives* transactions are deemed to be free of counterparty risk if they are performed on an exchange where the *clearing house* meets each of the following conditions:
- (a) it is backed by an appropriate performance guarantee; and
 - (b) it is characterised by a daily mark-to-market valuation of the *derivative* positions and an at least daily margining.
- (12) For the purposes of this *rule* a single body is:
- (a) in relation to *transferable securities* and money market instruments, the *person* by whom they are issued; and
 - (b) in relation to *deposits*, the *person* with whom they are placed.

Guidance on spread: general

- 5.7.6 G (1) *COLL 5.7.5R(8)* to (11) replicate the provisions of Article 5 of the Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities, so as to enable *non-UCITS retail schemes* to benefit from the same flexibility.
- (2) The attention of *authorised fund managers* is specifically drawn to condition (d) in *COLL 5.7.5R(9)* under which the collateral has to be legally enforceable at any time. It is the *FSA's* view that it is advisable for an *authorised fund manager* to undertake a legal due diligence exercise before entering into any financial collateral arrangement. This is particularly important where the collateral arrangements in question have a cross-border dimension. The *depository* will also need to exercise reasonable care to review the collateral arrangements in accordance with its duties under *COLL 6.6.4R* (General duties of the depository).
- (3) In applying the spread limit of 20% in value of *scheme property* which may consist of *deposits* with a single body, all uninvested cash comprising *capital property* that the *depository* holds should be included in calculating the total sum of the *deposits* held by it on behalf of the *scheme*.

Investment in collective investment schemes

- 5.7.7 R A *non-UCITS retail scheme* operating as a *FAIF* must not invest in *units* in a *collective investment scheme* (second *scheme*) unless the second *scheme* is a

scheme which satisfies the criteria in *COLL 5.6.10R(1)(a)* to (d) or meets each of the requirements at (1) to (4):

- (1) the second *scheme* operates on the principle of the prudent spread of risk;
- (2) the second *scheme* is prohibited from investing more than 15% in value of the property of that *scheme* in *units* in *collective investment schemes* or, if there is no such prohibition, the *non-UCITS retail scheme's authorised fund manager* is satisfied, on reasonable grounds and after making all reasonable enquiries, that no such investment will be made;
- (3) the *participants* in the second *scheme* must be entitled to have their *units* redeemed in accordance with the *scheme* at a *price*:
 - (a) related to the net value of the property to which the *units* relate; and
 - (b) determined in accordance with the *scheme*; and
- (4) where the second *scheme* is an *umbrella*, the provisions in (1) to (3) and *COLL 5.7.5R* (Spread: general) apply to each *sub-fund* as if it were a separate *scheme*.

- 5.7.8 R Feeder *schemes* which (in respect of investment in *units* in *collective investment schemes*) are *dedicated to units* in a single *collective investment scheme* must, in addition to the investment in the master *scheme*, only hold cash or *near cash* to maintain sufficient liquidity to enable the *scheme* to meet its commitments, such as *redemptions*. Feeder *schemes* may also use techniques and instruments for the purpose of *efficient portfolio management*, where appropriate, such as forward foreign exchange transactions entered into for the purpose of reducing the effect of fluctuations in the rate of exchange between relevant currencies.

Due diligence requirements

- 5.7.9 R (1) A *non-UCITS retail scheme* operating as a *FAIF* must not invest in *units* in *schemes* in *COLL 5.7.7R(1)* to (3) ('second *schemes*') unless the *authorised fund manager* has carried out appropriate due diligence on each of the second *schemes* and:
- (a) is satisfied, on reasonable grounds and after making all reasonable enquiries, that each of the second *schemes* complies with relevant legal and regulatory requirements;
 - (b) has taken reasonable care to determine that:
 - (i) the property of each of the second *schemes* is held in safekeeping by a third party, which is subject to prudential regulation and independent of the investment manager of

the second *scheme*;

- (ii) the calculation of the net asset value of each of the second *schemes* and the maintenance of their accounting records is segregated from the investment management function; and
- (iii) each of the second *schemes* is regularly audited by an independent auditor in accordance with international standards on auditing.

- (2) The *authorised fund manager* of a *non-UCITS retail scheme* operating as a *FAIF* invested in one or more second *schemes* must carry out appropriate due diligence as detailed in (1) on those *schemes* on an ongoing basis.

5.7.10 R The *authorised fund manager* of a *non-UCITS retail scheme* operating as a *FAIF* which is a feeder *scheme* must ensure that:

- (1) its master *scheme*; and
- (2) where its master *scheme* is itself a feeder *scheme*, any *scheme* into which that master *scheme* invests;

operates on a basis that is consistent with the *rules* in this section notwithstanding any due diligence previously carried out which suggested that those *schemes* would so operate.

5.7.11 G An *authorised fund manager* carrying out due diligence for the purpose of the *rules* in this section should make enquiries or otherwise obtain information needed to enable him properly to consider:

- (1) whether the experience, expertise, qualifications and professional standing of the second *scheme's* investment manager is adequate for the type and complexity of the second *scheme*;
- (2) the adequacy of the regulatory, legal and accounting regimes applicable to the second *scheme* and its investment manager;
- (3) whether the second *scheme*, its investment manager and administrator have complied with their legal and regulatory obligations, including but not limited to an evaluation of the investment manager's written policies with respect to such compliance;
- (4) the extent to which the second *scheme's* investment manager adheres to guidance and codes which amount to good practice in the industry;
- (5) the adequacy of the second *scheme's* systems, controls, governance, accounting, administration, business continuity, disaster recovery, safekeeping, custody and trading and execution arrangements;

- (6) the extent to which the property of the second *scheme* may be rehypothecated and the potential impact of such rehypothecation on the *non-UCITS retail scheme* operating as a *FAIF*;
- (7) the adequacy of the second *scheme's* risk management process, in particular:
 - (a) the methodology by which risk is measured and its practical adequacy in the light of the limitations inherent in risk measures (such as value at risk), including where appropriate, reference to market risk, credit risk (including counterparty credit risk), liquidity risk, operational risk and outsourcing risk;
 - (b) the extent to which the second *scheme's* investment manager carries out stress testing and backtesting, to determine how potential changes in market conditions could impact on the value of the second *scheme's* portfolio;
 - (c) the reporting, escalation and review processes within the second *scheme's* governance structure;
 - (d) the manner in which risks arising from services provided by third parties are managed, including where those third parties provide prime brokerage, administration, auditing, valuation, risk monitoring, business continuity and disaster recovery services; and
 - (e) the management of key person risk;
- (8) the adequacy of the second *scheme's* investment strategy and trading philosophy;
- (9) the implications of currency convertibility (if any);
- (10) whether the second *scheme* produces a valuation that is sufficiently accurate for the *authorised fund manager* to be reasonably satisfied that the price of the *FAIF's units* can be calculated in accordance with *COLL 6.3* (Valuation and pricing), including but not limited to an assessment of:
 - (a) the roles and responsibilities of each of the parties involved in the second *scheme's* valuation process and the extent to which these are defined;
 - (b) the extent to which the valuation process is segregated or is functionally separate from the second *scheme's* investment manager where the second *scheme* is not subject to completely independent valuation by a third party;
 - (c) the methods used by the second *scheme* for the valuation of each part of its property including those assets which are

- difficult to value or which are not subject to independent market pricing;
- (d) the extent to which the investment manager of the second *scheme* does not rely on prices from external sources, and its written policies relating to this;
 - (e) the manner in which the investment manager of the second *scheme* selects and monitors the adequacy of its pricing sources;
 - (f) the extent to which the investment manager of the second *scheme* operates a valuation policy that is consistent and fair to both subscribing and redeeming investors from the second *scheme*;
- (11) the level of liquidity, redemption policy and *dealing* arrangements offered by the second *scheme* and whether they are sufficient for the investing *scheme* to be able to meet its obligations in respect of redemptions; wherever appropriate the *authorised fund manager* may need to consider how many second *schemes* the investing *scheme* should invest in to ensure that that *scheme* can meet its redemption obligations; and
- (12) any relevant conflicts of interest that may arise out of the relationships of the second *scheme's* investment manager with other relevant parties and in particular detract from the integrity of the second *scheme's* decision-making process, including:
- (a) relationships with brokers or service providers;
 - (b) conflicts that may be generated by fee structures;
 - (c) use of dealing commission to purchase goods or services;
 - (d) conflicts that may arise from the second *scheme's* investment manager managing that *scheme* alongside other business; and
 - (e) the conflicts of interest that may arise (if any) between the second *scheme's* investment manager and any *person* instructed to carry out due diligence on the *authorised fund manager's* behalf.

Amend the following as shown.

Sale and redemption

6.2.16 R ...

- (5) ~~The~~ Except where (5A) applies the period in (4) expires at the close of business on the fourth *business day* following the later of:

...

- (5A) Where a non-UCITS retail scheme operating as a FAIF operates limited redemption arrangements, the period in (4) expires no later than the expiry of a period of 185 days from the date of receipt and acceptance of the instruction to redeem.

...

...

- 6.2.19 R (1) The *instrument constituting the scheme* and the *prospectus* of a *non-UCITS retail scheme operating as a FAIF*, or that invests substantially in immovables or whose investment objective is to provide a specified level of return, may provide for *limited redemption arrangements* appropriate to its aims and objectives.
- (2) Where (1) applies, the *scheme* must provide for *sales and redemptions* at least once in every six *months*.
- (3) Within a *scheme*, *unit classes* may operate different arrangements for ~~*redemption*~~ *sales and redemptions* of *units* provided there is no prejudice to the interests of any *unitholder*.
- (4) The *scheme* may provide for *sales of units of any class* to be executed at a greater frequency than *redemptions of units of the same class*.

...

Deferred redemption

- 6.2.21 R (1) ~~The~~ Subject to (1A) and (3) the *instrument constituting the scheme* and the *prospectus* of an *authorised fund* which has at least one *valuation point* on each *business day*, may permit deferral of *redemptions* at a *valuation point* to the next *valuation point* where the requested *redemptions* exceed 10%, or some other reasonable proportion disclosed in the *prospectus*, of the *authorised fund's* value.
- (1A) Subject to (3) the *instrument constituting the scheme* and the *prospectus* of a *non-UCITS retail scheme* operating as a *FAIF* may permit deferral of *redemptions* at a *valuation point* to a following *valuation point* where the requested *redemptions* exceed 10%, or some other reasonable proportion disclosed in the *prospectus*, of the *authorised fund's* value.
- (2) Any deferral of *redemptions* under (1) or (1A) must be undertaken in accordance with the procedures explained in the *prospectus* which must ensure:
- (a) the consistent treatment of all *unitholders* who have sought to *redeem units* at any *valuation point* at which *redemptions* are

deferred; and

- (b) that all *deals* relating to an earlier *valuation point* are completed before those relating to a later *valuation point* are considered.
- (3) Any deferral under (1A) is subject to the limitations on payments to unitholders in COLL 6.2.16R(5A).

...

Valuation points

6.3.4 R ...

- (6) Higher volatility funds must have at least one valuation point every business day except where the scheme is a non-UCITS retail scheme operating as a FAIF.

...

...

Table: contents of qualified investor scheme prospectus

8.3.4 R ...

...	
3	Investment objectives and policy
	...
(5)	<u>Where a scheme is a feeder scheme which (in respect of investment in units in a single collective investment scheme) is dedicated to units in a collective investment scheme, details of the master scheme and the minimum (and, if relevant, maximum) investment that the feeder scheme may make in it;</u>
...	

...

Application

...

- 8.4.1A R (1) Where this section refers to a second scheme, and the second scheme is a feeder scheme, which (in respect of investment in units in collective investment schemes) is dedicated to units in a single collective investment scheme, the reference in this section to the second scheme must be read as if it were a reference to any scheme into which the feeder scheme's master scheme invests.

(2) Where this section refers to a second *scheme*, and the second *scheme* is a master *scheme* to which (in respect of investment in *units* in *collective investment schemes*) the relevant *qualified investor scheme* is *dedicated*, the reference in this section to the second *scheme* must be read as if it were a reference to any *scheme* into which that master *scheme* invests.

...

8.4.5 R (1) A *qualified investor scheme* may invest in *units* in a *scheme* (a ‘second *scheme*’) only if the second *scheme* is:

~~(1)~~(a) a *regulated collective investment scheme*; or

~~(2)~~(b) a *scheme* not within ~~(1)~~(a) where the *authorised fund manager* has taken reasonable care to determine that:

~~(a)~~(i) it is the subject of an independent annual audit conducted in accordance with international ~~accounting~~ standards on auditing;

~~(b)~~(ii) it has its value verified by a *person* independent from its *operator* in relation to each *day* on which ~~dealing in that *scheme's units* may take place~~ the calculation of the net asset value of each of the *second schemes* and the maintenance of their accounting records is segregated from the investment management function;

~~(c)~~ there are mechanisms in place to enable *unitholders* to redeem their *units* within a reasonable time;

~~(d)~~(iii) (unless it is a master *scheme* to whose *units* the relevant *qualified investor scheme* is *dedicated*) it is prohibited from ~~having~~ investing more than 15% of its value in *units* of *schemes* or, if there is no such prohibition, the *qualified investor scheme's authorised fund manager* is satisfied, on reasonable grounds and after making all reasonable enquiries, that no such investment will be made; and

~~(e)~~(iv) it operates in accordance with the principle of risk spreading as described in COLL 8.4.2R.

(2) A *qualified investor scheme* must not invest more than 20% in value of the *scheme property* in *units* in *second schemes* which are unregulated *schemes* or *qualified investor schemes* unless the *authorised fund manager* has carried out appropriate due diligence on each of the *second schemes* and has taken reasonable care to determine that, after making all reasonable enquiries and on reasonable grounds, the second *scheme* complies with relevant legal and regulatory requirements.

- (3) The authorised fund manager of a qualified investor scheme with more than 20% in value of the scheme property invested in one or more second schemes which are unregulated schemes or qualified investor schemes must carry out appropriate due diligence on those schemes on an ongoing basis.

...

- 8.4.5B G (1) The guidance at COLL 5.7.11G applies to an authorised fund manager of a qualified investor scheme carrying out due diligence for the purpose of COLL 8.4.5R, as if that guidance related to COLL 8.4.5R.
- (2) Where COLL 5.7.11G(10) refers to COLL 6.3 (Valuation and pricing), that reference should be read as if it were a reference to COLL 8.5.9R (Valuation, pricing and dealing).
- (3) In addition to the guidance at COLL 5.7.11G the authorised fund manager should, as part of its due diligence process, consider whether the property of each of the second schemes is held in safekeeping by a third party, which is subject to prudential regulation and independent of the investment manager of the second scheme and, if not, what controls over the property of the second scheme are in place to protect investors.

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