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Financial Services Authority

Funds of Alternative Investment Funds (FAIFs)

Feedback on CP07/6 and
further consultation

February 2008



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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 22 May 2008.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/CP/2008/cp08_04_response.shtml).

Alternatively, please send comments in writing to:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

1 Overview

- 1.1 We published Consultation Paper (CP) 07/6 in March 2007. It concerned the introduction of retail-oriented funds of alternative investment funds (FAIFs). This followed on from our earlier work on wider-range retail investment products (Discussion Paper 05/3 and Feedback Statement 06/3) in which we explored the relevant risks, and asked whether our existing regime gave the appropriate degree of consumer protection as envisaged by the Financial Services and Markets Act 2000 (FSMA). The consultation closed on 27 June 2007 and we received 37 responses in total. We are grateful to the many respondents who gave us detailed and thoughtful ideas. This paper gives our feedback to the responses we received to CP07/6 and also consults further on three key issues.
- 1.2 In summary, we proposed introducing FAIFs into the existing non-UCITS retail schemes (NURS) regime by:
 - relaxing the existing NURS rules that restrict investment in unregulated collective investment schemes from 20%, instead allowing up to 100%;
 - removing the prescription of the 15% rule that prohibits circularity of investment within NURS and to extend this to the Qualified Investor Scheme (QIS) regime; and
 - applying due diligence criteria to the investment manager where they invest more than 20% into unregulated collective investment schemes.
- 1.3 Respondents agreed with most of our proposals and Chapter 2 of this paper presents the feedback we received for the issues that are now finalised.
- 1.4 However, three key areas were identified through the feedback, which require more consultation. These are explored in Chapter 3. In summary, we are consulting on:
 - master/feeder structures;
 - repayment standards; and
 - strengthened due diligence guidance.

- 1.5 In addition, to avoid any FAIF taxation regime being used to gain unintended tax advantages we are consulting on our proposal to include a ‘genuine diversity of ownership’ condition in our rules.

Structure of this paper

- 1.6 Chapter 1 sets out the background to this Consultation Statement (CP). Chapter 2 provides a summary of the feedback we received to CP07/6 and our response to that. Chapter 3 sets out our revised proposals in light of this with the associated cost benefit analysis in Annex 1 and Compatibility Statement in Annex 2. Annex 3 lists the consultation questions. Annex 4 lists the non-confidential respondents to CP07/6 and Appendix 1 contains the draft rules.

Who should read this CP?

- 1.7 This CP is of interest to investment managers, consumers (and groups representing them), investment advisers, relevant trade associations, commentators and analysts.

Next steps

- 1.8 This consultation will close on 22 May 2008. We will then finalise the draft rules in light of responses and give feedback in quarter 3 2008. This will set out the rule changes, if any, in their final form and give the date they will come into effect.

Consumers

This CP will be of interest to consumers who buy, or are considering buying, investments and to their representatives, advisers and consumer groups.

Our proposals will not lower the standards of consumer protection that exist within the current NURS regime. On the contrary, increasing investment flexibility will increase consumer choice in the investments they can buy, adding to their ability to, diversify risk, where appropriate.

Firms

We propose to introduce master/feeder structures into the NURS regime as well as provide strengthened rules and more detailed guidance on our due diligence approach. This will be of interest to investment managers, relevant trade associations, commentators and analysts. We believe these proposals will be most relevant to larger UK retail firms who may already operate funds of alternative investments. They may also be of interest to smaller firms who already offer these types of investments or who wish to operate feeder funds.

As our proposals are increasing the flexibility within the existing NURS regime, we do not expect there to be any significant increase in cost in complying with them. Instead we anticipate an increase in consumer choice, operational efficiency and market competition.

2 Background

- 2.1 In March last year we published our proposals for introducing retail-oriented Funds of Alternative Investment Funds (FAIFs) which would include, but would not be limited to, funds of hedge funds. This followed on from our earlier work that explored the rapidly changing landscape of retail investments and how we might best strike the right balance between ensuring consumers have enough access to an appropriate range of investment products, while securing the appropriate degree of consumer protection as envisaged by FSMA.
- 2.2 We undertook this review for several reasons:
- The offer and sale of wider-range investment products to retail consumers is subject to differing regulatory requirements. This means retail consumers may be confronted with those products in a variety of circumstances, and subject to differing conditions. We are concerned that consumers neither understand the nature of these products nor the differing regimes that apply to them.
 - Recent revisions to the UCITS Directive have meant that providers are now able to make use of more ‘advanced’ portfolio techniques, and what have typically been seen in the past as ‘hedge fund’ investment techniques are rapidly entering into the mainstream market.
 - Growing international interest by regulatory authorities in hedge funds – many other EU jurisdictions, notably France, Ireland, Luxembourg, Spain, Germany and Italy, have developed their own regimes to allow funds of alternative investment funds, specifically funds of hedge funds to retail consumers. We noted the E-Commerce Directive prevents us from prohibiting other EEA member states from selling to UK consumers electronically.
- 2.3 These developments had put stress on the existing regulatory arrangements in what has become a rapidly shifting environment. This prompted us to review and assess whether they remain effective in meeting our statutory objectives of consumer protection, public understanding and market confidence. We approached the existing rules by considering the risks they were intended to mitigate and whether a more high-level, principles-based approach could achieve better outcomes in terms of our statutory objectives.

- 2.4 Having completed our review, we concluded that the time was right to extend the range of investment products available within the retail market. We recognise that while some of these products may not be right for everyone or every investor's circumstances, some could add value through diversifying risk within a portfolio. Indeed, it could be argued the ability to diversify risk beyond the 'traditional' investment market has become more pressing in recent years when stock market returns have been particularly volatile. The issue is how best to apply regulatory control over access to and penetration of the retail market and secure the appropriate degree of consumer protection.
- 2.5 This led us on to the publication of CP07/6 (Funds of Alternative Investment Funds), which explored our proposals for that regulatory control.

3 Feedback on CP07/6

Introduction

3.1 CP07/6 asked 19 questions in total. In this chapter we give a summary of the responses received where our proposals have not changed substantially in light of the feedback. Chapter 4 contains feedback on the questions where we are making further proposals.

Q1: What types of product do you believe are likely to be developed as FAIFs, making use of the wider investment ability into unregulated schemes?

Q2: To what extent is it likely that the FAIF proposals would be used to create 'hybrid' schemes where unregulated schemes are held along with other NURS eligible assets, as opposed to pure funds of funds? What types of 'hybrid' scheme do you foresee being produced?

3.2 The majority of respondents welcomed the proposals for the wider investment ability into unregulated schemes. Most suggested that funds of hedge funds and funds of Jersey or Guernsey property funds were most likely to be developed as a result of the greater investment flexibility.

3.3 The greatest interest was focused largely on developing pure funds of funds. But some respondents expressed an interest in developing hybrid schemes using a broad mixture of underlying assets that could then be selected at the level of the FAIF. The assets would be chosen to meet a range of investor preferences, according to need and attitude towards risk.

Q4: What is your view about our proposal to approach the valuation question in the way suggested, bearing in mind the need to ensure that the prices of the FAIF must be accurately calculated?

- 3.4 We had proposed not to require FAIF underlyings to be subject to independent valuation. We based this on discussions with the industry who had told us that such a requirement would rule out most of the US hedge fund market, which is arguably the most mature in terms of age and experience. In addition, it is well documented that the matter of valuations can cause complex issues where ‘independence’ is concerned.
- 3.5 For example, in the UK the valuation of hedge funds and illiquid financial instruments typically involves third-party administrators (TPAs), which provide another level of challenge for valuations. However, for illiquid assets there is often no publicly agreed price for an asset, and TPAs may have to rely on either a valuation model, which is frequently developed by the hedge fund manager, or on price quotes from the hedge fund’s counterparties. These sources of price information may be insufficient to be considered truly independent. There can often be a wide dispersion in opinion among market participants as to the price at which the investments should be fairly marked for valuation purposes.
- 3.6 Many respondents argued against our proposal because they believed independent valuations provide a substantial amount of consumer protection. Valuation issues are important for all fund managers, but they present a particular challenge for those who use more illiquid instruments such as distressed debt, complex derivatives, real estate and private equity. The difficulty is that the manager is often themselves best placed (or indeed the only one in a position to be able) to give an accurate valuation, even when independent administrators are involved. This fundamentally calls into question how independent the valuation of those assets can ever realistically be.
- 3.7 There was a broad spectrum of views regarding what we should and should not permit.
- 3.8 In response to the feedback we have strengthened our due diligence approach. In addition much valuable work has been carried out in this area to develop codes of practice which provide detailed guidance that can be used as a supplement to due diligence. We think the combination of this in conjunction with our Training and Competence regime is the best approach to address this complex and difficult area.
- Q5: What is your view on the appropriateness and workability for FAIFs of a six-month limited redemption provision?
- Q6: Is a notice period required for FAIFs in addition to the existing limited redemption provision? If there were no notice period allowed, would FAIFs be likely to invoke deferred redemption provisions? If so, what is your estimate of the frequency of doing so?
- 3.9 In consultation we proposed applying the existing NURS standards to FAIFs, permitting six-monthly redemptions (as with limited redemption funds) but not allowing notice periods. Most respondents agreed with our approach to limited redemptions. However, most of the feedback argued that the regime would be inoperable without notice periods as these are an essential tool for managing fund liquidity. The FAIF manager needs to be able to match the FAIF’s redemptions with those of the underlying funds.

- 3.10 Several alternative suggestions were made to address the issue of liquidity management, the most popular being to increase the fund's ability to leverage. As is discussed later in this chapter we do not believe increased leverage is an appropriate solution so we do not intend to increase the leverage limits. One firm suggested that notice periods could already be applied as cut-off points under existing rules for limited redemption funds and this ability should be extended to FAIFs.
- 3.11 While we agree that the existing rules do relate to 'cut-off' points they are not, in our view, the same as the application of a notice period. We use 'notice period' in the sense that would apply to traditional deposit based accounts - a fixed number of days notice being required before the withdrawal of funds can take place without penalty. Provided the redemption request is received before the cut-off point the manager is required to redeem those units on the next dealing date, which must be no more than 185 days after the date of the redemption request¹. Given the nature of open-ended collective investment schemes it is difficult to see how 'notice periods' could be practically applied. We do not intend to change our approach with regard to notice periods but we would welcome any further views on our proposals.
- Q8: What are your views on our proposed approach to side pockets?
- 3.12 Most respondents agreed with our view that using side pockets within the underlyings should be left to the due diligence of the FAIF manager. So we do not propose to change our approach.
- Q9: What are your views on our proposed change to the '15% rule' making it a matter for the NURS scheme's manager to determine whether any scheme in which he might invest might in turn invest more than 15% of its assets in other collective investment schemes?
- Q10: What are your views on the proposed exception from the '15% rule' for feeder funds, permitting a NURS to invest in an unregulated scheme that is itself dedicated to investing all of its assets into one 'master' scheme?
- 3.13 NURS schemes are currently prohibited from investing in a second scheme except where the second scheme is itself prohibited from investing more than 15% of its assets in collective investment schemes. We created the 15% rule as a safeguard against the possibility of substantial cross-holdings between schemes, such as occurred within closed-ended investment trust companies.
- 3.14 It was clear from our research that FAIFs will not flourish with the 15% rule in place as it currently stands. So we consulted on the basis of four possible changes that could be made to the rule:

1. COLL 6.2.16R 'Where the authorised fund operates limited redemption arrangements, the authorised fund manager must sell or redeem units at a price determined no later than the expiry of a period of 185 days from the date of the receipt and acceptance of the instruction to sell or redeem'.

Option 1 – redrafting the rule so a feeder fund may invest 100% of its assets in its master fund, but with the proviso that the master itself must be prohibited from investing more than 15% of its assets in collective investment schemes.

Option 2 – redrafting the rules so a feeder fund may invest 100% of its assets in its master fund, and the manager of the investing NURS should be reasonably satisfied that no investment of more than 15% in other schemes will be made by the master fund.

Option 3 – redrafting the rule as guidance to the effect that the manager of any authorised scheme must guard against the circularity of capital through mutual cross-holdings between schemes.

Option 4 – abolishing the rule.

- 3.15 As stated in consultation, our preferred option was option 2 as we thought it would provide a sufficient safeguard against the circularity of capital through cross-holdings. As expected, responses varied with many preferring options 3 and 4.
- 3.16 While we recognise that many would favour the complete abolition of this rule, it must be remembered that it was intended to prevent the recurrence of the problems presented by split capital investment trusts (splits). Circularity of capital remains a risk, so we think it still plays a valuable role in consumer protection. The reason for our proposal to alter the prescription of the rule was that unregulated collective investment schemes are unlikely to be specifically limited by the rule requirements within their prospectuses. This does not imply they are invested beyond 15% in other schemes; it simply means it is unlikely their prospectus will prohibit them from doing so.
- 3.17 We still believe option 2 is the best approach to this issue – recognising the limitations that exist in documentation while retaining the consumer protection the rule provides. We intend to allow NURS to invest all of their assets in one underlying feeder, but this would only be the case where the underlying master itself was consistent with spreading risk.
- 3.18 This is the same approach as that we have taken in the Investment Entities Listing Review, where we have permitted feeder funds to list. The new provisions suggest a fund may be deemed to spread investment risk adequately when concentrating all of its capital in another fund. However, to do this the listed feeder fund’s board of directors must be satisfied the investment policy of the feeder fund and the master have consistent investment objectives, and the master fund does actually deliver the required level of diversification of risk. We do not propose any other changes to the investment limits for NURS.
- 3.19 In consultation this led on to the question of whether and to what extent we should allow NURS to act as feeder funds themselves – we discuss this in Chapter 4 of this paper.

Q13: What are your views on the proposal that FAIFs should be subject to the same borrowing limit as other NURS?

- 3.20 Leverage proved to be a controversial issue - mainly because respondents felt that without notice periods they would need a greater ability to leverage to manage fund liquidity and overcome liquidity constraints.
- 3.21 Recognising regulatory concerns around borrowing within the fund, many firms suggested that increased borrowing powers could be divided into two categories. First, the ability to borrow for portfolio efficiency requirements; and, second, the ability to borrow to meet redemption requests, with respective limits for each. While we can understand the arguments for permitting an increased use of leverage above the current restriction of 10%, we remain concerned about the potential impact this could have on consumer protection.
- 3.22 We do not believe significant fund borrowing is appropriate. It also raises a question of fairness – essentially disinvesting individuals would effectively be leveraging those investors remaining in the fund.
- 3.23 For this reason we do not intend to alter the existing NURS rules regarding leverage. We are however including in this paper a question on whether the NURS repayment standards need to be changed and whether this would help to ease the management of fund liquidity.

Q14: What are your views on the proposal to continue the existing aggregation of unregulated schemes with the 20% limit for unapproved securities?

- 3.24 The NURS rules currently allow a maximum aggregate investment of 20% into unregulated schemes and unapproved securities. (For example, where a scheme holds 5% in unregulated schemes there is headroom for it to additionally hold up to 15% in unapproved securities.)
- 3.25 The consultation proposed abolishing the limit for unregulated schemes – effectively allowing up to 100% investment, while retaining the aggregate limit for unapproved securities. Essentially, where a NURS invests more than 20% in unregulated schemes there is no ability to additionally hold any unapproved securities. We considered this restriction to be an important investor protection to safeguard liquidity within the fund.
- 3.26 Many respondents argued the 20% aggregate limit was arbitrary and that unapproved securities are, in themselves, no more illiquid than unregulated schemes. In addition, respondents argued that keeping this rule would greatly impede product development in the FAIF regime.
- 3.27 Despite the number of respondents who argued against our proposed approach to this issue, we remain concerned about the impact that relaxing this rule further may have on fund liquidity and consequently on the retail consumer's ability to disinvest from the fund within a reasonable period. While we understand the arguments raised, the fact remains that unapproved securities are not listed and there may not necessarily be a market for those underlyings when the fund manager needs to disinvest.
- 3.28 While the management of fund liquidity is ultimately a matter for the fund manager, we believe from a consumer protection point of view it is important – at least until FAIFs are well established – to keep a degree of regulatory control over FAIF

liquidity. It is likely that consumers will be unfamiliar with ‘alpha’ style funds and it is essential they are able to redeem the proceeds of their investments within an acceptable timescale regardless of market conditions. So we do not propose any changes to the existing aggregate rules for unapproved securities.

Q15: Are there any other NURS rules, which we have not identified, that should be changed to accommodate the development of FAIFs? If so, please give full reasons as to why and how the regime would require amendment.

- 3.29 No other specific NURS rule changes were suggested in response to this question. However, the matter of disclosure was raised by many as an issue of concern. Feedback identified we should require firms to provide greater disclosure for FAIFs than those currently applied to more traditional NURS.
- 3.30 Under the current disclosure regime, NURS providers can choose to produce either a key features document (KFD) or a simplified prospectus (SP). Both of these regimes need clear consumer communication. For KFDs, firms are required to ‘include enough information about the nature and complexity of the product, how it works, any limitations or minimum, standards that apply and the material benefits and risks of buying or investing for a retail client to be able to make an informed decision about whether to proceed²’. The SP requires, among other disclosures, firms to give consumers ‘a short description of the scheme’s objectives including a concise and appropriate description of the outcomes sought for any investment in the scheme and a brief assessment of the scheme’s risk profile by investment compartment including a description in words of any risk investors have to face in relation to their investment’.³
- 3.31 In addition, clear information is central to Treating Customers Fairly (TCF) and our overall regulatory approach. For example, Principle 7 of our Principles for Businesses requires firms to pay ‘due regard to the information needs of consumers and to communicate information in a way that is clear, fair and not misleading’.
- 3.32 So we believe the existing disclosure requirements are sound, but industry standards need to improve. Our 2008 Financial Risk Outlook (FRO) reinforced our findings from our review of the quality of firms’ KFDs – where consumers can be disadvantaged by information imbalances that exist between themselves, product providers and distributors. It noted that some products now entering the retail market have typically only been available to sophisticated or institutional investors in the past. This means the accompanying materials may not include the risk descriptions and explanations needed by a less sophisticated retail investor.
- 3.33 The industry plays a key role in helping consumers to understand and meet their financial needs. This role is becoming increasingly important as retail products become more complex and opaque against the backdrop of low consumer financial capability. Firms have considerable freedom to produce well-designed documents which meet our objectives and help consumer understanding – explaining products clearly, avoiding legalistic and unhelpful jargon. More detailed rules cannot address the fact that firms need to be more thoughtful in their communications with consumers.

2. Conduct of business sourcebook (COBS) 13.3.1R

3. Collective Investment Scheme sourcebook (COLL) 4.6.8R

Q16: (a) What is your view on the draft rules included at Annex 4?

(b) What is your view about the use of a due diligence approach in regulating the nature of the underlying investments of a FAIF? What are your views on the due diligence Guidance proposed?

- 3.34 Most respondents agreed with the draft rules included in CP07/6. Although, as set out under question 3 (see next chapter), many asked for more guidance around the issues of valuation, pricing models and managing conflicts of interest. Almost all agreed that a due diligence approach was the most appropriate method to regulate the nature of the underlying investments.
- 3.35 Some respondents asked whether due diligence only applied to the percentage of the fund invested in unregulated schemes, while others raised questions about inadvertent breaches of the 20% limit.
- 3.36 We would expect all fund managers of authorised schemes to carry out appropriate due diligence on all underlying investments as a matter of course, regardless of whether they are managing a FAIF. But where a NURS invests more than 20% in unregulated schemes, the manager must be able to demonstrate the whole of the fund complies with our due diligence requirements. Fund managers should be proactively monitoring their portfolios to ensure they are consistent with the stated investment objectives and so we hope that inadvertent breaches would be rare. However, where this is unavoidable, the fund manager will need to consider how significant the breach was and take the appropriate notification and corrective actions.

Q17: What are your views on the case study?

- 3.37 Very few respondents commented on the case study; those that did expressed concerns that we were suggesting FAIFs should only be sold through the provision of advice. In addition, on the matter of advice, some suggested we should apply additional training and competency requirements for those advisers choosing to sell FAIFs to retail consumers.
- 3.38 The case study was designed to illustrate the entire 'product lifecycle', including the respective responsibilities of providers and distributors. For completeness, we included an intermediary in the example. We did not intend to imply that FAIFs could not be bought or sold on an execution-only basis. However, given the potentially unique and novel nature of the products, it is possible that not all FAIFs will be appropriate for wide retail consumption or for sale without the provision of advice. Firms will need to consider their methods of distribution in accordance with our TCF principles.
- 3.39 Our 2007 FRO reminded asset managers of their responsibilities to be fully conversant with their responsibilities in selling products through all types of intermediary. They also need to develop effective product design and targeting strategies. In addition, asset managers need to enhance their understanding of their distributor intermediaries to facilitate the fair treatment of consumers. This message remains valid, especially for FAIFs given the potential heightened complexity of products and possible consumer needs.

- 3.40 With regard to the application of additional training and competency standards, our recent work has exposed concerns over the standards of professionalism and competence in firms, with some advisers having inadequate levels of training and experience. There is a risk that a lack of professionalism can lead to firms providing poor-quality advice. A great deal of work is currently being carried out in this area, for example, as part of the Retail Distribution Review.
- 3.41 The existing Training and Competence regime makes it clear that staff must have and continue to have the knowledge and skills necessary to carry out their roles. The implication of this for individuals and firms will differ depending on the nature of their business. While this is primarily a matter for the employee and employer, product providers can and do have an active role in training intermediaries. In addition, product providers have a responsibility to be satisfied their distributors are competent to carry out that role.
- 3.42 We do not intend to apply any additional qualification requirements for advisers wishing to sell FAIFs. Advisers are already required to act in the best interests of their consumers and, where consumers receive advice, the advice must be suitable and take account of their circumstances. Where customers receive a recommendation, the advice must reflect their needs, priorities and circumstances. This is regardless of the method of the adviser's remuneration.

Q18: Do you agree that the due diligence requirements will not impose additional compliance costs of more than minimal significance?

- 3.43 As anticipated, feedback to this question tended to depend on both the size and experience of the respondent concerned. Broadly, views reflected our expectations – that most smaller firms would find the compliance costs greater than larger retail firms (already operating funds of alternative assets), who would find them of minimal significance.

Q19: Do you have any comments on the cost benefit analysis (CBA)?

- 3.44 Respondents made very few comments about the CBA, with most firms broadly agreeing with our analysis.

Other matters

- 3.45 Two issues were raised by most respondents in their feedback. Specifically:
- Will FAIFs be eligible as individual savings accounts (ISAs)?
 - Are FAIFs eligible as permitted links?
- 3.46 The answers to both these questions will depend on the nature of the FAIF itself, as well as whether the firm thinks it is appropriate for them to be so.

- 3.47 If firms can comply with the ISA rules, there is no reason why a FAIF could not be an ISA vehicle. However, they would be prohibited from operating limited redemption provisions. Due to the nature of the underlying assets a FAIF may not be able to meet the ISA requirements.
- 3.48 For permitted links, FAIFs will be NURS so will be eligible as a permitted link investment.

4 Further consultation

- 4.1 In this chapter we note the feedback received in the areas where we are making revised proposals (questions 3, 7, 11 and 12 from CP07/6). We have not repeated the questions here to avoid confusing them with the questions we are seeking feedback on in this paper. In addition we are seeking views on our proposals to include a genuine diversity of ownership condition in the FAIF rules.

Repayment standards (Question 7 in CP07/6)

- 4.2 The current NURS rules require a repayment standard of four business days (commonly known as T+4)⁴. We had proposed to leave this unchanged for the FAIF regime. However, respondents strongly argued against this because, by their nature, funds of funds need to obtain valuations from the underlying funds which, in the case of hedge funds and other hard to value assets, may take some time.
- 4.3 It was pointed out that applying existing repayment standards could result in funds paying out on estimated net asset values (NAVs) provided at, or shortly after, the relevant valuation point, which would not be in the interests of investors or fund managers.
- 4.4 One firm suggested that we allowed an additional thirty days for FAIFs to settle redemption proceeds. While we recognise the difficulties firms face when disposing of more illiquid assets, the problem with this approach is that it carries with it issues concerning the holding of client money which we believe make it inoperable in practice. It is the nature of open-ended collective investment schemes that the NAV used to deal units is to some degree estimated. Fund of funds can suffer to a greater extent as the fund's NAV is dependent on the availability and accuracy of the underlying NAVs. Delays to the repayment of redemptions would not compensate the fund for any difference between the NAV used to deal units and the realised value of

4. COLL 6.2.16R (4) *'on agreeing to a redemption of units in (3) the authorised fund manager must pay the unitholder the proceeds of redemption within the period specified in (5) unless the authorised fund manager has reasonable grounds for withholding all or any part of the proceeds.'*

COLL 6.2.16R (5) *'The period in (4) expires at the close of business on the fourth business day following the later of: (a) the valuation point at which the price for the redemption was determined; or (b) the time when then authorised fund manager has all the duly executed instruments and authorisations to effect (or enable the authorised fund manager to effect) the transfer of title to the units.'*

the underlying assets. However, we would welcome views on whether repayment standards need to be changed and if so, what rule changes would be necessary to accommodate FAIFs.

Q1: (a) Do we need to make any changes to the existing 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?

Master/feeder structures (Questions 11 and 12 in CP07/6)

4.5 In CP07/6 we asked whether, and to what extent, FAIFs (and NURS more generally) should be allowed to be feeder funds. While we recognised the benefits of permitting them to be, there were two main arguments that led us to believe it was not appropriate to propose it at the time. Specifically:

- the European Commission was considering a similar question within a UCITS context and if we pre-empted its conclusions, there was a risk our rules may have run contrary to an EU-wide proposal; and
- more importantly, there were the regulatory and consumer protection risks posed by an offshore master fund, where in effect, we would only be authorising the onshore FAIF investment ‘shell’ without having any direct regulatory control over the underlying investments.

4.6 Since then, we have reconsidered our policy position for the following reasons:

- the European Commission has now published its consultation on the shape of changes to UCITS funds. This includes proposals for UCITS to be able to act as feeder funds.
- as expected, feedback to the consultation argued strongly in favour of permitting master/feeder structures. Many firms already operate successful FAIFs offshore. They see no economic benefit in having to replicate similar funds in the UK purely to access the UK retail market. Given that these firms are well-established and experienced in operating FAIF style investments, it seems unjustifiable to us to force them to recreate onshore what they already have elsewhere.
- the Treasury has published its proposals and draft regulations to introduce a new tax regime for property authorised investment funds (PAIFs)⁵. The master/feeder structure may be required by life companies to avoid breaching PAIF regulations⁶.

5. ‘Property Authorised Investment Funds – a discussion paper’ July 2007 & ‘Property authorised investment funds – next steps’ December 2007.

6. PAIF draft regulations restrict corporate investors from beneficially holding 10% or more of the fund which could cause significant issues for life companies who tend to have more substantial holdings in such funds.

- 4.7 Accepting that NURS should be allowed to act as feeder funds, the question becomes one of how we address the associated regulatory and consumer protection risks.
- 4.8 We have engaged in discussion with both internal and external stakeholders to explore how best to resolve the risks posed by offshore master funds. In feedback many suggested a ‘common control’ requirement, where effectively both the master and feeder funds are required to be operated by the same corporate management. While in theory this seemed an attractive solution, in practice we think it could carry with it some unintended tax consequences that could make it unfeasible. In addition, the essence of ‘alpha’ style investment techniques is that they are unique and often innovative. As a result, many hedge funds are independently operated and not part of a larger corporate group so would automatically be excluded by such a rule.
- 4.9 Having explored various options, our preferred solution is to include a requirement within our rules that where a NURS is a feeder fund, the manager must ensure that its master scheme 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 failure of the master fund to do so remains the responsibility of the manager of the feeder fund, ‘notwithstanding any due diligence carried out.’
- 4.10 Given the current level of financial capability among retail consumers, it is important that complex charging structures are explained effectively. In our recent review of KFDs we found instances of good practice, but other instances where individual charges are explained well but the combined effect of those charges is not. This could potentially be exacerbated in master/feeder structures.
- 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.

Due diligence approach (Question 3 in CP07/6)

- 4.11 In CP07/6 we set out our proposals for a due diligence-based approach. Respondents agreed that the due diligence covered all of the matters with which an investment fund manager should concern himself before making an investment into an underlying scheme. However, while many agreed with our approach, some asked for more detailed guidance, specifically in relation to valuations, the use of pricing models and managing conflicts of interest.
- 4.12 The guidance was intended to act as a standard setting tool and as a gateway – allowing through only those managers with enough skill and expertise to competently manage FAIFs.
- 4.13 Given the diverse assets and strategies that could potentially emerge in FAIFs, it is not possible to devise a prescriptive ‘one-size fits all’ approach. So we developed the guidance to accommodate diversity and retain the potential for innovation and change.

- 4.14 Manager competence is at the heart of the FAIF regime. Striking the right balance between principle and prescription is core to securing fund manager responsibility and the consequent consumer protection.
- 4.15 However, we do recognise some firms would like the additional comfort that our rules and guidance can provide. So, in response to the feedback, we have strengthened the due diligence rules and guidance and included criteria for managers where the NURS is acting as a feeder fund.
- 4.16 The guidance is a framework for good practice, but given the potentially unique nature of some of the products that could develop firms will need to consider how it specifically applies to the individual FAIF. They may wish to supplement their due diligence processes with additional material as appropriate to their needs, for example the International Organisation of Securities Commissions (IOSCO) 'Principles for the valuation of hedge fund portfolios' (November 2007).

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

Genuine diversity of ownership

- 4.17 As stated in CP07/6, several difficult tax issues are involved with the proposal to allow greater investment freedom for UK managers in the form envisaged by the FAIFs regime, specifically in relation to the UK offshore funds tax regime. We have continued to work closely with the Treasury to find a way for FAIFs to operate competitively within the UK retail market.
- 4.18 As with any taxation framework (recent examples of which are UK Real Estate Investment Trusts (UK REITs) and PAIFs) it is important to avoid, where possible, the framework being used for purposes it was not designed for, i.e. to obtain unintended tax advantages. In many regimes this is achieved by 'ring-fencing' those to whom or whom it does not apply. For UK REITs, this was achieved by limiting access to the regime to companies that are not 'close' (i.e. not controlled by five or fewer participants); and for PAIFs, recognising the challenges posed by collective investment schemes, by including a condition of 'genuine diversity of ownership'.
- 4.19 We have developed the regulatory regime for FAIFs specifically to allow wider retail access to a greater choice of investments. But there is a long-recognised risk with the authorised investment funds regime that private individuals may club together to gain unintended benefits. Given that the proposed tax regime will be elective, it is necessary for us to include a genuine diversity of ownership condition in our rules, similar to that proposed in the draft regulations for PAIFs.
- 4.20 As set out in this paper, FAIF-style investments are already available to retail consumers in a number of forms – offshore, via listed securities and via the internet. Allowing onshore products will provide retail investors with the benefit of UK regulatory protection. To make the FAIF regime effective, we are proposing to match the genuine diversity of ownership conditions that will apply to PAIFs to FAIFs. This

should achieve a consistent approach and the intended outcomes. The conditions are set out below and in the draft rules in Appendix 1.

- 4.21 The Treasury's discussion paper issued in December 2007 outlined the draft regulations for the genuine diversity of ownership conditions which we have modified here to apply to both open-ended investment companies (OEICs) and authorised unit trusts (AUTs)

The genuine diversity of ownership condition is that the *instrument constituting the scheme* and the *scheme's prospectus* (including any supplements to the prospectus specify and continue to specify:

- (a) that *units* in the *scheme* will be widely available and the intended categories of investors;
- (b) that its investors most comprise a large number of *persons* that are not *associates*;
- (c) that *units* in the *scheme* must be marketed and made available:
 - (i) sufficiently widely to reach the intended categories of investors; and
 - (ii) in a manner appropriate to attract those categories of investors;
- (d) that any *person* within the intended categories of investors must be able to acquire *units* in the *scheme* easily, and must be able to acquire them in the same way as a *person* may acquire *units* in other *authorised funds* that are widely available;
- (e) that the minimum investment in the *scheme* must not be unreasonably high in view of the risk profile of the *scheme*; and
- (f) that, in comparison with charges imposed on larger investors, charges imposed on smaller investors must not be greater than:
 - (i) is commercially normal and reasonable; and
 - (ii) the charges imposed by other *authorised funds* that are widely available.

- 4.22 Firms that choose to produce FAIFs would need to include these conditions in the instrument of incorporation or the trust deed and the prospectus of the OEIC / AUT as appropriate.

Q4: Do you have any comments on this proposal?

Cost Benefit Analysis (CBA)

Introduction

We are required under the Financial Services and Markets Act 2000 (FSMA) to publish an “estimate of the costs together with an analysis of the benefits that would arise if the proposed rules were made”. Under section 155(8) of FSMA, an analysis is not required if the resulting increase in costs is of minimal significance. We consider that the changes we propose to make on FAIFs (Funds of Alternative Investment Funds) following the consultation on CP07/6 and set out in this CP warrant a CBA.

Feedback identified three key areas where we needed to reconsider our original approach. In addition, to avoid any FAIF taxation regime being used to gain unintended tax advantages we are consulting on our proposal to include a ‘genuine diversity of ownership’ condition in our rules.

To address this we are consulting on 3 main policy proposals:

- (a) Permitting master/feeder structures
- (b) Strengthening the due diligence guidance; and
- (c) Including a ‘genuine diversity of ownership’ condition.

In addition, we are seeking views on whether the repayment standards for NURs need to be changed to accommodate FAIFs. A CBA is not included for this in this CP, however, a full analysis will be carried out should feedback indicate that changes are necessary.

This further CBA sets out our analysis of the new proposals.

Master/feeder structures

Benefits

The introduction of the master/feeder structure should, on the whole, reduce operational costs for firms as it removes the necessity to replicate onshore an existing offshore fund purely to gain access to the UK retail market. Overall we expect this to increase operational and cost efficiency in firms producing FAIFs.

Master/feeder structures may facilitate retail consumer access to alternative products through the accessibility of offshore master funds which may otherwise be unavailable.

Whether this generates a net benefit for consumers would depend on the additional diversification and the net risk-adjusted returns those master/feeder funds can provide.

Benefits depend also on consumer characteristics as master/feeder structures which include FAIF style investments have potentially complex investment strategies and instruments which may be difficult to liquidate immediately by investors. Our 2008 Financial Risk Outlook stressed the risk related to a lack of consumer understanding of new and potentially complex financial products. This risk could be exacerbated in master/feeder funds due to the double structural layer which may create greater opacity in the underlying investments. Depending on the master fund strategy pursued FAIF master/feeder funds may only be suitable for a small number of retail consumers. For these consumers master/feeder funds which include FAIF style investments should form only a small amount of a broader investment portfolio containing more liquid investments.

Costs

The introduction of master/feeder structures can lead to the risk of a double layer of management charges. This could cause consumer detriment through excessive costs and the resulting effect on fund performance after charges. Consumers may not fully understand the effect the charges may have on the overall investment and the charges may not be transparent given the double structural layer.

Master/feeder structures can involve offshore master funds. As those offshore funds may not meet UK regulatory standards, this can give rise to regulatory and consumer protection risks. We consider these risks will be reduced by our strengthened due diligence rules and more detailed guidance in conjunction with FSA supervision.

Due diligence procedures

Compared to CP07/6 we have strengthened our due diligence rules. We have also provided more detailed guidance - particularly in the areas of valuations and managing conflicts of interest. In addition we have made the necessary adjustments to allow the operation of master/feeder structures. We remain of the view that it is more likely to be larger retail firms who already have the required expertise who will choose to operate FAIFs.

This view was confirmed by the feedback received to CP07/6 where larger retail firms who already had experience in investing and managing alternative assets said that the production of FAIFs would incur little, if any, additional cost. Smaller firms, however, who believed they would need to acquire the necessary skills and experience to produce FAIFs felt that compliance with our rules would prove too great a cost for there to be any economic benefit in doing so although no specific amounts were mentioned in the feedback provided. Therefore we expect firms that will produce FAIFs to already have a risk management process in place that is analogous to the proposed due diligence guidance.

For small firms the principal benefit of the strengthened due diligence procedure is the mitigation of regulatory and consumer protection risk arising from FAIF master/feeder structures. However, feedback from small firms indicates that this may come at the cost of less small firms being able to enter the market for FAIFs.

For large firms choosing to produce FAIFs, the additional costs and benefits of the strengthened due diligence procedures are likely to be of minimal significance.

Genuine diversity of ownership condition

To avoid any taxation regime being used to gain unintended tax advantages we propose to include a 'genuine diversity of ownership' condition in our rules. This condition is similar to the draft proposals that will apply for Property Authorised Investment Funds (PAIFs).

We do not believe that compliance with these conditions will result in any significant costs to firms. The spirit of the authorised investment funds regime is to provide access to a larger pool of underlying investments and therefore risk diversification than a retail investor could generally achieve for themselves, without creating tax disadvantages compared with direct investment in those assets. If a FAIF is genuinely produced for retail investment we would expect that it could satisfy the genuine diversity of ownership conditions with little, if any, additional cost.

Direct Costs for the FSA

In the case of master/feeder structures closer supervisory attention will be required where the master fund is located in an offshore jurisdiction. However, given our continuing closer engagement with hedge fund managers and prime brokers, and the current principle locations of hedge funds, we do not expect those costs to be significant. In the case of FAIFs (and NURS more generally) acting as feeder funds, we do not expect there to be a material increase in our supervision or regulatory costs.

We have strengthened the due diligence rules and guidance in response to the feedback received. Generally we do not expect this to present an increase of burdens on our resources. A possible exception would be the monitoring of the underlying fund in the case of master/feeder structures.

We intend to conduct a post implementation review to assess the effectiveness of the FAIF regime. Whilst this could pose some additional resource requirements we do not anticipate this will be the case as we expect it to be undertaken within our normal thematic work.

In general, as stated in CP07/6 we do not expect an immediate influx of FAIFs seeking authorisation should these proposals be implemented. This results from our experience with the introduction of UCITS III funds. Thus we remain confident that we will be able to deal with FAIFs in the context of business as usual without the need for the allocation of additional resources.

Q5: Do you have any comments on the CBA?

Compatibility statement

This section explains our reasons for concluding that the proposals set out in this CP are compatible with our general duties under section 2 of FSMA and our regulatory objectives set out in sections 3 to 6.

Compatibility with statutory objectives

The proposals set out in this CP are primarily designed to help us to meet our objective of consumer protection and to a lesser degree market confidence.

Consumer protection

The proposed strengthened due diligence requirements should ensure the quality of the FAIF's underlying portfolio. Furthermore, current FSA requirements should contribute to address information asymmetries and help to avoid mis-selling. Overall, we expect consumers of FAIFs to be provided with an appropriate degree of protection.

Market confidence

By broadening the existing NURS regime within the existing framework of our well-regulated collective investment schemes regime we believe our proposals will reinforce and enhance market confidence by permitting greater flexibility and encouraging innovation within this sector whilst securing the appropriate degree of consumer protection.

Principles of good regulation

Section 2(3) of FSMA requires that, in carrying out our general functions, we have regard to the specific matters set out below.

- a. The need to use our resources in the most efficient and economic way*

As discussed in the cost-benefit analysis we believe the proposed principle based rules are consistent with the efficient and economic use of FSA resources.

- b. the responsibilities of those who manage the affairs of authorised persons*

We still aim to focus responsibility for carrying out the appropriate degree of due diligence on senior management.

- c. The principle that a burden on restriction which is imposed on a person, or on the carrying out of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction*

We have undertaken a cost benefit analysis to help to shape our proposals and inform this consultation as well as a detailed analysis of the feedback received to CP07/6. We remain of the view that the costs are proportionate to the anticipated benefits. In addition, we anticipate that firms will only produce FAIFs if it is economical for them to do so.

- d. The desirability of facilitating innovation in connection with regulated activities*

Our proposed rules will facilitate innovation in investment management, product design and distribution to retail investors. By removing the 20% investment restriction in unregulated schemes in conjunction with permitting master/feeder structures both firms and consumers will have access to a wider range of potential investment products. Managers already have greater flexibility to use advanced investment techniques under UCITS III and our proposals will allow a greater ability to make use of these in the NURS regime.

- e. The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom*

The proposed rule changes should help UK-domiciled firms to compete at an EU level as this will allow them to market products that are already permissible in other EU jurisdictions. The revisions to our rules may encourage firms currently domiciled in other jurisdictions to relocate to the UK.

- f. The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions*

Our cost benefit analysis does not indicate any material adverse impacts of our proposed changes on competition.

- g. The desirability of facilitating competition between those who are subject to any form of regulation by the FSA*

Where possible we have attempted to bring our regulations into line with non-COLL business, e.g. the Listing Rules. Life companies could also take advantage of the proposed wider investment powers for NURS, this should help to facilitate competition.

b. Acting in a way which we consider most appropriate for the purpose of meeting our statutory objectives

We consider that there are positive effects from allowing firms to market FAIFs to UK retail investors. We remain concerned about the possible information asymmetries that could potentially arise from this. However, we consider overall that the proposed principles-based regime is better suited to protect consumers rather than prescriptive rules whilst allowing them to benefit from the opportunity of greater investment choices.

The new, principles-based regime is also more adaptable to changing markets and should limit the burden on firms. Overall, we consider the proposed new FAIF regime is the most appropriate way to achieve our statutory objectives.

List of consultation questions

- Q1: (a) Do we need to make any changes to the existing 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?
- 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.
- Q3: What are your views on the proposed strengthened due diligence?
Are there any other matters that need to be taken into consideration?
- Q4: Do you have any comments on this proposal?
- Q5: Do you have any comments on the CBA?

List of non confidential respondents to CP07/6

Association of Independent Financial Advisers (AIFA)

Alternative Investment Management Association (AIMA)

AVIVA Plc

Bank of Ireland Asset Management

Barclays Wealth

BlackRock Investment Management (UK) Ltd

British Bankers' Association (BBA)

Cazenove Capital Management Ltd

Depositories and Trustees Association (DATA)

Dexion Capital

Dundas-Wilson

Eversheds LLP

Fidelity Investments International

The Financial Services Consumer Panel

Friends Provident

GAM

Hargreaves Lansdown Asset Management Ltd

HSBC

Investment and Life Assurance Group (ILAG)

Investment Management Association (IMA)

Insight Investment

JP Morgan Asset Management

KPMG
L&G
Matrix
M&G
Optima
Randle Williams
Sabrefund
Schroders Investment Management Ltd
Scottish Widows
St James' Place
Standard Life
T Bailey
Thames River Capital
Threadneedle Asset Management
Zurich

Draft Instrument

FUNDS OF ALTERNATIVE INVESTMENT FUNDS INSTRUMENT 2008

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 139(4) (Miscellaneous ancillary matters);
 - (c) section 156 (General supplementary powers);
 - (d) section 157(1) (Guidance); and
 - (e) section 247 (Trust scheme rules); and
 - (2) regulation 6(1) (FSA rules) of the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. The Annex to this instrument comes into force on [... 2008].

Amendments to the Handbook

- D. The Collective Investment Schemes sourcebook (COLL) is amended in accordance with the Annex to this instrument.

Citation

- E. This instrument may be cited as the Funds of Alternative Investment Funds Instrument 2008.

By order of the Board
[... 2008]

Annex

Amendments to the Collective Investment Schemes sourcebook (COLL)

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

5.1.4 G Indicative overview of investment and borrowing powers

...

Scheme investments and investment techniques	Limits for <i>UCITS</i> schemes		Limits for <i>non-UCITS retail schemes</i>	
	Permissible investment	Maximum limit	Permissible investment	Maximum limit
...				
Unregulated <u>schemes and qualified investor schemes</u>	No	N/A	Yes	20% <u>None (C)</u>
...				
Note:	Meaning of terms used:			
...				
“N/A”	...			
“(C)”	<u>Caveat: although a <i>non-UCITS retail scheme</i> may invest up to 100% in value of the <i>scheme property</i> in unregulated <i>schemes and qualified investor schemes</i>, if it also invests in certain <i>transferable securities</i> an aggregate investment limit may apply – see <i>COLL 5.6.5AR</i></u>			

5.6.1 R ...

(2) Where this section ~~contains a reference~~ refers to:

- (a) a rule or guidance in ~~any of~~ *COLL 5.1 to COLL 5.5*, these rules and guidance and any rules and guidance to which they refer ~~or any relevant guidance should~~ must be read as if ~~any a~~ references to a *UCITS scheme* is a reference to a *non-UCITS*

retail scheme;

- (b) a second scheme, and the second scheme is a feeder scheme, the reference in this section to the second scheme must be read as if it is a reference to the feeder scheme's master scheme; and
- (c) a second scheme, and the second scheme is a master scheme into which the relevant non-UCITS retail scheme invests all its scheme property, the reference in this section to the second scheme must be read as if it is a reference to the master scheme and any scheme into which that master scheme invests.

5.6.2 G (1) ...

- (2) Some examples of the different investment and borrowing powers under the *rules* in this section for *non-UCITS retail schemes* are the power to:

...

- (b) invest in up to 100% of the value of the scheme property in unregulated schemes and qualified investor schemes or up to 20% in aggregate of the value of the *scheme property* in *transferable securities* which are not *approved securities* and *unregulated schemes*;

...

Transferable securities, and money-market instruments and unregulated schemes

5.6.5 R ...

5.6.5A R To the extent that any part of the scheme property consists of transferable securities which are not approved securities, the aggregate of the value of those securities and any units in unregulated schemes or qualified investor schemes must not exceed 20% of the value of the scheme property.

5.6.7 R ...

- (6) Except for a feeder fund or a non-UCITS retail scheme which is a feeder scheme that invests all its scheme property into a master scheme, not more than 35% in value of the *scheme* is to consist of the *units* of any one *scheme*.

...

Investment in collective investment schemes

5.6.10 R A *non-UCITS retail scheme* must not invest in *units* in a *collective*

investment scheme (second *scheme*) unless the second *scheme* meets each of the requirements at (1) to (5):

- (1) ~~the second *scheme*:~~
 - (a) ~~satisfies the conditions necessary for it to enjoy the rights conferred by the *UCITS Directive*; or~~
 - (b) ~~is a *non-UCITS retail scheme*; or~~
 - (c) ~~is a *recognised scheme*; or~~
 - (d) ~~is constituted outside the *United Kingdom* and the investment and borrowing powers of which are the same or more restrictive than those of a *non-UCITS retail scheme*; or~~
 - (e) ~~is a *scheme* not falling within (a) to (d) and in respect of which no more than 20% in value of the *scheme property* (including any *transferable securities* which are not *approved securities*) is invested; [deleted]~~
- (2) the second *scheme* operates on the principle of the prudent spread of risk;
- (3) the second *scheme* (unless it is a master *scheme* into which the relevant *non-UCITS retail scheme* invests all its *scheme property*) is prohibited from having investing more than 15% in value of the property of that *scheme* consisting of 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;

...

- 5.6.10A R (1) A *non-UCITS retail scheme* must not invest more than 20% in value of the *scheme property* in units in unregulated *schemes* and *qualified investor schemes* (together, the 'second *schemes*') unless the *authorised fund manager* of the investing *scheme* has:
- (a) taken reasonable care to determine that each of the second *schemes* is regularly audited by an independent auditor in accordance with *international accounting standards*; and
 - (b) carried out appropriate due diligence on each of the second *schemes* and is satisfied, on reasonable grounds and after making all reasonable enquiries that they comply with relevant legal and regulatory requirements.
- (2) The *authorised fund manager* of a *non-UCITS retail scheme* with more than 20% in value of the *scheme property* invested in one or more second *schemes* must carry out further appropriate due diligence

on those schemes on an ongoing basis.

- 5.6.10B R The authorised fund manager of a non-UCITS retail scheme which is a feeder scheme must ensure that its master scheme and any scheme into which that master scheme invests operate on a basis that is consistent with the rules in this section.
- 5.6.10C G The authorised fund manager of a non-UCITS retail scheme which is a feeder scheme will remain responsible for any failure to operate on a basis that is consistent with the rules in this section by its master scheme or any scheme into which that master scheme invests notwithstanding any due diligence carried out which suggested that those schemes would so operate.
- 5.6.10D 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 of a standard at least equivalent to that required by FIT;
 - (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, trading and execution arrangements;
 - (6) 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;
- (7) the adequacy of the second *scheme's* investment strategy and trading philosophy;
- (8) the implications of currency convertibility (if any);
- (9) 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 investing *scheme'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 independent valuation takes place and the impact of any lack of independent valuation on the integrity of the overall valuation process; where the second *scheme* is not subject to independent valuation, the *authorised fund manager* may need to carry out other appropriate checks, for example, into the valuation model used;
 - (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* calculates or verifies the accuracy of prices independently of the valuations carried out by the second *scheme's* trading and portfolio management functions; and

(g) 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 offered by the second *scheme* and whether it is sufficient for the investing *scheme* to be able to meet its obligation to redeem the *units* of its investors on request; 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 soft commission (soft dollar) arrangements;

(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.

5.6.10E R (1) A non-UCITS retail *scheme* must not invest more than 20% in value of the *scheme property* in *units* in unregulated *schemes* and *qualified investor schemes* unless the investing *scheme* satisfies and continues to satisfy the genuine diversity of ownership condition set out in (2).

(2) The genuine diversity of ownership condition is that the *instrument constituting the scheme* and the *scheme's prospectus* (including any supplements to the *prospectus*) specify and continue to specify:

(a) that *units* in the *scheme* will be widely available and the intended categories of investors;

(b) that its investors must comprise a large number of *persons* that are not *associates*;

(c) that *units* in the *scheme* must be marketed and made available:

(i) sufficiently widely to reach the intended categories of investors; and

- (ii) in a manner appropriate to attract those categories of investors;
 - (d) that any person within the intended categories of investors must be able to acquire units in the scheme easily, and must be able to acquire them in the same way as a person may acquire units in other authorised funds that are widely available;
 - (e) that the minimum investment in the scheme must not be unreasonably high in view of the risk profile of the scheme; and
 - (f) that, in comparison with charges imposed on larger investors, charges imposed on smaller investors must not be greater than:
 - (i) is commercially normal and reasonable; and
 - (ii) the charges imposed by other authorised funds that are widely available.
- 6.2.19 R (1) *The instrument constituting the scheme and the prospectus of a non-UCITS retail scheme that investing more than 20% of its scheme property in unregulated schemes and/or qualified investor schemes, 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.*
- ...
- 8.4.1 R ...
- 8.4.1A R (1) Where this section refers to a second scheme and the second scheme is a feeder scheme, the reference to the second scheme must be read as if it is a reference to the feeder scheme's master scheme.
- (2) Where this section refers to a second scheme and the second scheme is a master scheme into which the relevant qualified investor scheme invests all its scheme property, the reference in this section to the second scheme must be read as if it is a reference to the master scheme and 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)(a) *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~~ international accounting standards;
- (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; [deleted]
- (e)(iii) there are mechanisms in place to enable ~~unitholders~~ to redeem their ~~units~~ within a reasonable time; [deleted]
- (d)(iv) (unless it is a master scheme into which the relevant qualified investor scheme invests all its scheme property) 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)(v) ...

(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 of the investing scheme has carried out appropriate due diligence on each of the second schemes and is satisfied, on reasonable grounds and after making all reasonable enquiries, that they comply 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 further appropriate due diligence on those schemes on an ongoing basis.

8.4.5B R The authorised fund manager of a qualified investor scheme which is a feeder scheme must ensure that its master scheme and any scheme into which that master scheme invests operates on a basis that is consistent with the rules in this section.

8.4.5C G The authorised fund manager of a qualified investor scheme which is a feeder scheme will remain responsible for any failure to operate on a basis that is consistent with the rules in this section by its master scheme or any scheme into which that master scheme invests notwithstanding any due diligence carried out which suggested that those schemes would so operate.

- 8.4.5D G An authorised fund manager carrying out due diligence for the purpose of the rules in this section should consider the guidance at COLL 5.6.10DG.
- 8.4.5E R (1) A qualified investor scheme must not invest more than 20% in value of the scheme property in units in unregulated schemes and qualified investor schemes unless the investing scheme satisfies and continues to satisfy the genuine diversity of ownership condition set out in (2).
- (2) The genuine diversity of ownership condition is that the instrument constituting the scheme and the scheme's prospectus (including any supplements to the prospectus) specify and continue to specify:
- (a) that units in the scheme will be widely available and the intended categories of investors (being in any event within one or more of the categories set out in COLL 8 Annex 1 (Qualified investor schemes: eligible investors));
 - (b) that its investors must comprise a large number of persons that are not associates;
 - (c) that units in the scheme must be marketed and made available:
 - (i) sufficiently widely to reach the intended categories of investors; and
 - (ii) in a manner appropriate to attract those categories of investors;
 - (d) that a person qualified to invest must be able to obtain information about the scheme and acquire units in it without difficulty;
 - (e) that the minimum investment in the scheme must not be unreasonably high in view of the risk profile of the scheme;
 - (f) that, in comparison with charges imposed on larger investors, charges imposed on smaller investors must not be greater than:
 - (i) is commercially normal and reasonable; and
 - (ii) the charges imposed by other authorised funds that are widely available.

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