

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Guidance Notes to the Applicable to Collective Investment Schemes Licensed in Malta.

17th October 2008

Background

MFSA proposes to issue the following two Guidance Notes relating to collective investment schemes:

- Guidance Note 1 – Guaranteed Collective Investment Schemes
- Guidance Note 2 – Use of Side Pockets by Professional Investor Funds

MFSA invites any comments with respect to the above proposed Guidance Notes – as attached to this Circular - by close of business of the **4th November, 2008**.

Guidance Note 1 – Guaranteed Collective Investment Schemes

The aim of this guidance note is to further clarify the applicable requirements to Collective Investment Schemes wishing to include the term “*Guaranteed*” in their name or in the name assigned to their Sub-Funds.

Essentially, this Guidance Note lays down the conditions which must be met and the disclosures which must be made in the relative Prospectus / Offering Memorandum by such Collective Investment Schemes or their relative Sub-Funds.

This Guidance note is applicable to all types of Collective Investment Schemes – i.e. retail UCITS and Non- UCITS and all Professional Investor Funds.

Guidance Note 2 – Use of Side Pockets by Professional Investor Funds

This Guidance Note applies only to Professional Investor Funds targeting Qualifying Investors. It provides guidance for such Schemes wishing to address issues arising where certain assets within the Scheme’s portfolio become illiquid or comparatively hard to value by creating “Side Pockets”.

The creation of a “Side Pocket” normally involves the designation of an asset as illiquid or hard to value and the transfer of that asset into a specifically created new class of units (or Side Pocket) within the fund and the conversion of the corresponding Units held by investors in the fund into side pocket Units or the issue

of new Units in the side pocket. Thus illiquid or comparatively hard to value assets are separated from the main pool of more liquid investments allowing continued issue and redemption of Units in the liquid pool while reducing the risks highlighted above.

The Guidance note also indicates the disclosures which would need to be inserted in to the Offering Memorandum of the Schemes wishing to establish Side Pockets.

Contacts

Should you have any queries with respect to the above, please do not hesitate to contact Dr. Sarah Pulis on 25485232 or spulis@mfsa.com.mt.

Guidance Note 1: Guaranteed Collective Investment Schemes

This Guidance Note should be read in conjunction with the Investment Services Rules for Retail Collective Investment Schemes and the Investment Services Rules for Professional Investor Funds and applies to licensed Retail Collective Investment Schemes and Professional Investor Funds.

1.0 Introduction

- 1.1 The MFSA must generally be satisfied with the proposed name of the Scheme and where applicable its Sub-Funds.
- 1.2 This guidance note applies to Retail Collective Investment Schemes and Professional Investor Funds and their Sub-Funds (where applicable) whose name includes the term “guaranteed” or which will be marketed as “guaranteed” funds.
- 1.3 The MFSA will not permit the use of the word “guaranteed” in the name of a Scheme or its Sub-Fund (where applicable) nor will it allow a Scheme or its Sub-Fund to be marketed as “guaranteed funds” unless there is a specific legally enforceable guarantee between the Scheme and a legally independent third party, for the benefit of the unit holders. The Prospectus/ Offering Memorandum of the Scheme shall disclose the material provisions of the guarantee.

2.0 Requirements

- 2.1 Schemes wishing to include the term “guaranteed” in their name or in the name of any Sub-Funds or which intend to be marketed as a “guaranteed” funds are required to satisfy the following requirements:
 - i. the guarantee should be given by a person subject to prudential supervision to the satisfaction of the MFSA; provided that neither the Custodian nor the Manager of the Scheme or its Sub-Fund may act as guarantor. Provided further that the MFSA may accept as guarantor, an entity which had been entrusted/ delegated with certain investment management duties by the Board of Directors of a ‘self-managed’ Scheme;
 - ii. the guarantee must be evidenced by means of a contract e.g. a deed of guarantee or an irrevocable letter of credit, which is legally enforceable;

- iii. the contract should not contain onerous provisions in respect of the Scheme or its Sub-Fund, as applicable which would permit the guarantor to invalidate the guarantee;
- iv. the MFSA is to be satisfied that the guarantor has the authority and resources to honour the terms of the guarantee;
- v. the guarantee should cover all unit holders within the Scheme or its Sub-Fund, as applicable and be legally enforceable by each unit holder who is intended to benefit from it or by a person acting on that unit holder's behalf;
- vi. the guarantee is to relate to the total amount paid for a unit which may or may not include any charge or other costs related to buying or selling units in the Scheme or its Sub-Fund, as applicable or as may otherwise be provided in the Prospectus/ Offering Memorandum, provided that there is clear disclosure of precisely what is guaranteed;
- vii. the guarantee is to provide for payment at a specified date or dates and is to be unconditional although reasonable commercial exclusions such as force majeure may be included; and
- viii. the Prospectus / Offering Memorandum issued by the Scheme should disclose, in a prominent position, the following material issues relating to the guarantee and the guarantor:
 - Information about the guarantor which should include at least the name, contact details, regulatory status and other corporate information relating to the corporate structure of the guarantor , date of incorporation and the names of its directors.
 - A description of the agreement entered into between the Scheme or its Sub-Fund and the guarantor for the purposes of providing the guarantee. In particular, this description shall set out how the agreement is intended to ensure that the guaranteed payments will be duly serviced;
 - Details of the terms and conditions and the scope of the guarantee. Including :
 - obligations of the Scheme under the guarantee;
 - any condition on the application of the guarantee in the event of any default under the terms of the Scheme's Prospectus and under the agreement entered into between the Scheme or its Sub-Fund and the guarantor for the purposes of providing the guarantee;

- the guarantor's power of veto, if any, in relation to changes to the unit holders' rights under the Scheme's Prospectus / Offering Memorandum.
- a warning to the effect that eventual performance of the guarantee is dependent on the solvency of the guarantor; and
- where relevant, the impact on investors who sell their units prior to the maturity of the guarantee.
- An indication of the place where the public may have access to the material contracts and other documents relating to the guarantee.

3.0 Confirmation from the Legal Adviser of the Scheme

- 3.1 The Scheme will be expected to provide the MFSA with a letter from its legal advisors confirming that the guarantee satisfies the requirements outlined in paragraphs (iii) and (v) above.

Guidance Note 2: Use of Side Pockets by Professional Investor Funds

This Guidance Note should be read in conjunction with the Investment Services Rules for Professional Investor Funds and applies to licensed Professional Investor Funds targeting Qualifying or Extraordinary Investors.

1.0 Introduction

- 1.1 Side pockets are devices used by some hedge funds as a means of addressing issues arising where certain assets within the fund's portfolio become illiquid or comparatively hard to value. Where an asset is illiquid, this may affect the ability of the fund to realise the asset (or realise the asset at a reasonable price) in order to meet redemption obligations. Where an asset can not be valued accurately, the risk arises that prices for any subscriptions and redemptions in respect of the relevant portfolio of the fund will not accurately reflect the fair value of the relevant asset with the resulting concentrative and dilutive effects for investors. The creation of a side pocket normally involves the designation of an asset as illiquid or hard to value and the transfer of that asset into a specially created new class (or Side Pocket) within the fund (and conversion of the corresponding fund Units held by investors into side pocket Units or the issue of new Units in the side pocket). Thus illiquid or comparatively hard to value assets are separated from the main pool of more liquid investments allowing continued issue and redemption of Units in the liquid pool while reducing the risks highlighted above.
- 1.2 Typically, at the point that an asset enters a Side Pocket class, only the existing participants in the fund acquire Units in the Side Pocket (pro rata to their interest in the Side Pocket asset). Subsequent investors in the fund will not acquire an interest in the existing Side Pockets but will acquire interests in any future Side Pockets.
- 1.3 Side Pocket investments are typically valued at cost (or the value at which they were transferred into the Side Pocket) until circumstances are such that a revaluation can be made.
- 1.4 This guidance note applies to Professional Investor Funds targeting Qualifying or Extraordinary Investors which contemplate to use Side Pockets when and if such need arises. Licensed Maltese UCITS/ Non UCITS Scheme and Professional Investor Funds targeting Experienced Investors may not use Side Pockets.

2.0 Use of Side Pockets

Schemes which have constituted sub-funds

- 2.1 A Professional Investor Fund which has issued one or more classes of Units constituting a Sub-Fund may allocate certain assets within the portfolio of that Sub-Fund (generally illiquid assets or those that cannot be reliably valued) to a Side Pocket (within the same Sub-Fund). The Scheme will be required to create and issue a new class of Units within the same Sub-Fund (or take equivalent steps). The illiquid/ hard to value assets will be allocated to the Side Pocket so established. Existing investors in the Sub-Fund will in turn be allocated a pro rata holding in the new class of units representing the illiquid assets. The other classes of units within the Sub-Fund will accordingly cease to have an interest in the illiquid assets. This re-allocation of the illiquid assets to the new class of units will result in a diminution in the net asset value of these classes of units, although the Fund may opt for possible alternatives such as conversion of units into side pocket units (rather than the issue of new side pocket units without cancelling existing units), to avoid an adverse effect on performance figures, fee calculations etc.
- 2.2 In view of the fact that the new class of units constituting the Side Pockets will be created within the same Sub-Fund, the rules relating to the segregation of assets and liabilities will continue to apply. Thus the illiquid assets referred to above may be used to satisfy any other obligations relating to the other classes of units within the same Sub-Fund.

Schemes which have not constituted sub-funds

- 2.3 A Professional Investor Fund which has issued one or more classes of units which do not constitute a Sub-Fund may allocate part of its portfolio (generally illiquid assets) to a Side Pocket. The Scheme will be required to create and issue a new class of units (the Side Pocket) and allocate the illiquid assets to such class of units. Existing investors in the Scheme will in turn be allocated a pro rata holding in the new class of units representing the illiquid assets. The other classes of units within the Scheme will accordingly cease to be exposed to the illiquid assets. This re-allocation of the illiquid assets to the new class of units will result in a diminution in the net asset value of the original classes of units.

General

Practical Example

To illustrate, a Scheme has issued Class A units which constitute the first Sub-Fund of the Scheme (Sub-Fund 1). Sub-Fund 1 had an investment in a listed security which has recently been delisted. The Directors of the Scheme resolved to allocate this holding to a Side Pocket to be created within the same Sub-Fund. The Scheme will thus be required to:

- Create a new class of units within Sub-Fund 1 (Class B);
- Allocate the holding in the unlisted security to the new Class B within the same Sub-Fund;
- Issue/convert/allocate Class B Units to existing holders of the Class A Units pro rata to their holding in the Class A Units or pro rata to the interest in the asset.

Depending on the mechanism for allocating Side Pocket Units to investors, the Net Asset Value of the Class A Units will decrease in view of the removal of the illiquid Security from the portfolio of assets representing such Class A Units within Sub-Fund 1.

Existing investors in the Class A Units will continue to be exposed to the illiquid security via their holding of Class B Units (as indicated above). Subsequent investors in the Class A Units will not be issued Class B Units but may acquire interests in any future Side Pockets.

In view of the above, the Side Pocket classes [of units] within the same Sub-Fund will not give an entitlement to the assets in the main liquid portfolio of the Sub-Fund and each Side Pocket class will [generally] be exposed exclusively to the illiquid security.

3.0 Disclosure to investors

3.1 The Offering Memorandum of the Scheme would need to include the following information disclosed in a clear fair and not misleading manner:

- the nature of the assets that may be allocated to Side Pockets and the circumstances in which such allocations may be made; the procedure for the allocation of investments to Side Pockets;
- the procedure to be followed by the Scheme in the redemption or re-conversion of the units representing the Side Pocket; [*Note. Some funds may seek to re-convert the Side Pocket asset back into the main class when it is subject to a “liquidity event” (such as an IPO, trade sale or if it otherwise becomes liquid or capable of valuation. Alternatively, some funds may reserve the option (either to the fund or investors) to redeem or reconvert on a liquidity event.)*]
- limits on the size of Side Pockets, including the maximum percentage of the fund / sub-fund which can be allocated to Side Pockets in aggregate.
- policies for the valuation of assets allocated to a Side Pocket [*Note. In line with the best practice recommendations of the Hedge Fund Working Group¹ (HFWG), it is expected that the initial valuation of an asset on entering a Side Pocket is at cost, the latest available market price (as appropriate) or a lower value or nil*];
- fee structure relating to the class of units representing the Side Pocket; and [*Note. In line with HFWG’s best practice recommendations, in the case of Management fees, it is expected that these are calculated on the*

¹ January 2008 – Hedge Fund Standards: Final Report

basis of the lower of cost and fair value and that performance fees are not crystallised before the asset is disposed of or becomes liquid.]

- relevant risk warnings, in particular arising from the fact that Side Pocket assets may be hard to value, the illiquidity of Side Pocket assets and associated restrictions in realising interests in such assets.