

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Professional Investor Funds targeting Experienced Investors

Feedback Statement

10th September 2009

1.0 Background

- 1.1 On 21st May 2009, the Malta Financial Services Authority (“MFSA”) issued a circular describing the proposed review of the ‘Investment Services Rules applicable to Professional Investor Funds targeting Experienced Investors’. These proposed changes included the introduction of certain investment restrictions applicable to the Funds in question, the proposed revision to the definition of Experienced Investor and a reduction on the minimum investment threshold.
- 1.2 The industry was requested to submit any comments in relation to the draft revised ‘Investment Services Rules for Professional Investor Funds targeting Experienced Investors’ by end June 2009.
- 1.3 The MFSA received feedback from the Malta Funds Industry Association and a local law firm.
- 1.4 This Feedback Statement outlines (in no particular order) the main issues raised during the consultation process and the MFSA’s views on these issues. It also presents – in Annex 1 hereto – the proposed Rules (with tracked changes for ease of reference) which the MFSA has updated following consideration of all feedback received.
- 1.5 The MFSA is open to consider any further comments which may be received in relation to the changes indicated in the attached proposed Rules, within the timeframe indicated in the covering note to this Feedback Statement.
- 1.6 Subject to any further changes which the MFSA considers appropriate following consideration of any final feedback received in response to this Feedback Statement (para. above refers), it is envisaged that the final version of these Rules will be published and become operative by not later than 1st January 2010. Professional Investor Funds targeting Experienced Investors licensed before such date will have the option to reduce their minimum investment limit to Euro 10,000 subject to compliance with the proposed revised Rules OR to continue subject to the current regulatory requirements.

2.0 Comments Received

A. General Comments

Professional Investor Funds (“PIFs”) targeting Experienced Investors which are not operated according to the ‘risk spreading’ principle

2.1 A question was raised as to whether MFSA would permit the establishment of PIFs targeting Experienced Investors who also meet the criteria set out in the proviso to the definition of collective investment scheme in the Investment Services Act¹ applicable for the mandatory ‘risk spreading’ principle to be disapplied.

MFSA’s position:

2.2 MFSA considers that it will indeed be possible for such schemes to be established, in which case, they would be granted a waiver from the proposed investment restrictions.

Investment Restrictions based on the value of total assets rather than on the scheme’s net assets value

2.3 It was proposed that – in line with the approach taken for UCITS schemes for example – the proposed percentage investment restrictions could be based on the scheme’s total assets rather than net assets. This would still ensure diversification whilst allowing the scheme to take larger absolute positions given also their ability to engage in limited leverage

MFSA’s position:

2.4 MFSA agrees with the proposed approach and the relevant conditions have been updated accordingly.

Definition of Experienced Investors (para 2.2 of Annex 1)

2.5 A query was raised as to whether the proposed amendment to the definition of Experienced Investor to include persons who fall under the MiFID definition of ‘Professional Investor’, will also apply to currently licensed Experienced Investor PIFs.

¹ Such as persons whose ordinary business involves the acquisition and disposal of property of the same kind as the property, or a substantial part of the property, in which the scheme or arrangement invests

MFSA's position:

- 2.6 The MFSA considers that this clarification / revised Experienced Investor definition should apply across the board to all Experienced Investor PIFs (both those under the 'old regime' and those to fall under the 'new regime')

Assessment of Leverage

- 2.7 Reference was made to SLC 1.39 of the current Rules for Experienced Investor PIFs, which currently provides that "*Direct borrowing for investment purposes and leverage via the use of derivatives is restricted to 100% of NAV etc.*". MFSA was requested to consider extending this SLC to provide that leverage should be assessed on the basis of the VaR or the Commitment Approach set out in section 13 of Part B.II of the Investment Services Rules for Retail Collective Investment Schemes, in order to clarify the expected assessment of leverage methodology.

MFSA's position:

- 2.8 MFSA agrees with this suggestion and proposes that SLC 1.39 be elaborated accordingly.

Notional Exposure to Transferable Securities and Money Market Instruments

- 2.9 Reference was made to SLC 5.20 applicable to UCITS schemes, which reads as follows:

"Where the Scheme invests in Financial Derivative Instruments as part of its investment policies and within the limits established by SLC 5.36, the exposure to the underlying assets shall not exceed in aggregate the limits in SLC 5.6 to SLC 5.10, 5.12, 5.14, 5.35 and 5.36. The exposure to the underlying assets should be calculated using the Commitment Approach as indicated in Section 13 of this Part."

It was pointed out that the proposed restrictions for Experienced Investor PIFs do not include an equivalent condition.

MFSA's position

- 2.10 MFSA considers that in order to avoid the by-passing of the investment restrictions applicable to transferable securities, money market instruments etc, through the use of Financial Derivative Instruments which give a notional exposure to such assets, the following condition may be added:

'Investment by the Scheme in Financial Derivative Instruments as part of its investment policy in order to obtain exposure to underlying assets, shall be without prejudice to the limits set out in these Rules which apply in the case of direct investments in such underlying assets. The exposure to the underlying assets should be calculated using the Commitment Approach indicated in Section 13 of Part B.II of the Investment Services Rules for Retail Collective Investment Schemes.'

Use of Repurchase/ Reverse Repurchase and Stock Borrowing/ Stock Lending Agreements

- 2.11 MFSA was requested to consider extending the Rules to include a reference to the use of Repurchase/ Reverse Repurchase and Stock Borrowing/ Lending Agreements by Experienced Investor Funds in line with SLC 19.1 of Part B.II of the Investment Services Rules for Retail Collective Investment Schemes.

MFSA's position

- 2.12 MFSA agrees with this suggestion and proposes the addition of the following condition:

'A Scheme may only enter into repurchase/ reverse repurchase and stock lending/ borrowing agreements:

- (i) When in the opinion of the Scheme or its Manager, the entering into such agreements by the Scheme is appropriate and in the interest of investors in the Scheme, and entails an acceptable level of risk; and*
- (ii) In accordance with good market practice, which involves the provision of adequate collateral in accordance with good market practice to the satisfaction of the Scheme or its Manager'*

Furthermore MFSA considers that the prescriptive rules on collateral applicable to UCITS schemes should not be applied to Experienced Investor PIFs.

B. Specific Comments

The lettering below relates to that included in Annex 1.

Proposed Condition (a) which reads as follows:

The Manager or (in the case of a self-managed scheme), the Scheme, must take reasonable steps to ensure that the Scheme is managed according to the risk spreading principle. In particular, the Scheme shall be required to adhere to the diversification requirements set out below. In the case of a Scheme investing in alternative assets, the MFSA may impose tailored investment restrictions.

- 2.13 Reference was made to the phrase: “*In the case of a Scheme investing in alternative assets, the MFSA may impose tailored investment restrictions*”. It was suggested that this be removed as it may send a message of uncertainty and may be perceived negatively by promoters whilst the MFSA will nonetheless have the power to issue ad hoc licence conditions.

MFSA's position

- 2.14 For clarity's sake, MFSA prefers to retain the above sentence which is relevant for schemes ‘investing in alternative assets’ i.e. non traditional asset classes.

Proposed Condition (b) which reads as follows:

The Scheme may invest up to 20% of its net assets in securities issued by the same body and up to 30% of its assets in money market instruments issued by the same body provided that...etc.

- 2.15 It was pointed out that the 20% maximum exposure to unlisted securities issued by one issuer would be too restrictive for private equity funds and a maximum 50% cap was proposed with a minimum of three investments to be undertaken within twelve months from launch.

MFSA's position

- 2.16 Considering that private equity funds may also be set up in the form of Qualifying or Extraordinary Investor PIFs, the MFSA does not consider that the proposed 20% maximum limit should be altered. However the MFSA is proposing the introduction of a condition equivalent to SLC 4.3 for non UCITS retail schemes (reproduced below) to provide the scheme with some time to comply with the restrictions:

‘The Scheme shall comply with the investment restrictions within six months from the launch of the Scheme or upon reaching a value equivalent to Eur 2.5 million whichever is the sooner. However, the Scheme will, provided it considers this to be in the best interest of its shareholders and that it observes the principle of risk-spreading, not be required to comply with its investment restrictions upon reaching a value equivalent to Eur 2.5 million subject to it complying with such restrictions within a maximum of six months from launch. The Scheme shall take all reasonable steps to comply with the investment

restrictions. The Custodian shall supervise the operation of the Scheme or the Manager to ensure that the Scheme complies with the investment restrictions”

Proposed Condition (b) (ii) which reads as follows:

The Scheme may invest up to 20% of its net assets in securities issued by the same body and up to 30% of its assets in money market instruments issued by the same body provided that:

- (i)*
- (ii) The 20%/30% limits set out in (b) above may be increased to a maximum of 35% in the case of securities and money market instruments guaranteed by a credit institution authorised in the EEA or which is subject to equivalent prudential requirements.*

2.17 It was suggested that the 20%/30% limit be extended to securities and money market instruments ‘issued’ in addition to those ‘guaranteed’ by a Credit Institution.

MFSA’s position

2.18 MFSA does not consider this appropriate, given that it is the existence of a guarantee rather than the nature of the issuer itself which is the basis for the more flexible investment limit.

Proposed Condition (c) which reads as follows:

The Scheme may invest up to a maximum of 30% of its net assets in deposits held with a single body.

2.19 It was argued that if an Experienced Investor PIF can invest 35% of its net assets in securities guaranteed by Credit Institutions, the limit for deposits which carry a lower risk, should be increased to 35% of net assets as well.

MFSA’s position

2.20 MFSA agrees with this proposal and the condition has been revised accordingly.

Proposed Condition (g) which reads as follows:

Where the Scheme enters into OTC derivative transactions, it shall ensure that its exposure to a single counterparty is limited to 20% of its net assets

2.21 It was commented that there needs to be more clarity regarding the manner of required calculation of counterparty risk exposure, which should be on a net basis and which may be reduced via the use of collateral. In this regard, it was suggested that the rules applicable for UCITS schemes may be used as a basis for clarifying such requirements. With regards to the use of collateral to reduce counterparty risk exposure, the following wording was suggested:

'The exposure to one counterparty in an OTC derivative transaction may be reduced where the counterparty provides the Scheme with acceptable collateral in accordance with good market practice to the satisfaction of the Scheme or its Manager'

MFSA's position

2.22 MFSA acknowledges that it would be preferable to clarify the issues raised above and agrees with the proposed wording indicated above regarding the use of collateral. In addition, MFSA is also proposing that this condition be clarified through the inclusion of the following additional conditions:

The exposure per counterparty of an OTC derivative should not be measured on the basis of the notional value of the OTC derivative, but on the maximum potential loss incurred by the Scheme if the counterparty defaults.

The Scheme may net the mark-to-market value of its OTC derivative positions with the same counterparty, thus reducing the Scheme's exposure to its counterparty, provided that the Scheme has a contractual netting agreement with its counterparty which creates a single legal obligation such that, in the event of the counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the Scheme would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions.

Proposed Condition (h) which reads as follows:

The Scheme shall limit its aggregate maximum exposure (through securities, money market instruments, deposits and OTC derivative transactions) to a single issuer/counterparty to 40% of its net assets.

2.23 It was proposed that given the maximum limit relating to exposure to one counterparty/ issuer takes into account deposits with one institution, the limit should be increased to 50% of net assets so that when adopting a defensive

strategy during turbulent times, the Manager would not need to open bank accounts with at least three institutions.

MFSA's position

- 2.24 MFSA considers that that a maximum aggregate exposure of 40% of the fund's assets to one single institution should not be increased in order to ensure adequate risk diversification.

C. Comments specific to property funds

Property Funds Policy

- 2.25 MFSA was asked to consider including a cross reference to MFSA's Property Funds Policy in Part B.I. or Part A of the PIF Rules

MFSA's position:

- 2.26 MFSA agrees that the Investment Services Rules for PIFs should include a reference to the MFSA Property Funds Policy and where this may be found on the MFSA's web-site. Such a reference may be included in Part B.I of the Rules.

Investment through SPVs

- 2.27 It was suggested that the restrictions be extended to provide that the Scheme may invest up to 100% of its assets in one SPV provided that the applicable investment, borrowing and leverage restrictions are satisfied at the level of the SPV.

MFSA's position

- 2.28 MFSA agrees with this suggestion given that SPVs are simply investment vehicles and one can adopt a look through approach in their regard.

Investment in a single property fund - proposed condition (k) which reads as follows:

The Scheme shall not invest more than 30% of its net assets in any single property fund.

- 2.29 MFSA was requested to consider allowing PIFs targeting Experienced Investors to invest in a single property fund to the extent that the target property fund complies with the investment, borrowing and leverage

restrictions applicable to an Experienced Investor PIF set up as a property fund as well as with MFSA's Property Funds Policy.

MFSA's position

- 2.30 In line with the approach adopted as per condition (d), MFSA considers that condition (k) may – as suggested above - include a proviso to permit investment in a single property fund where such fund complies with the investment, borrowing and leverage conditions applicable to Experienced Investor PIFs established as property funds which are set out in the Rules and MFSA's Property Funds Policy.

ANNEX 1

Proposed Up-dated Investment Restrictions to be incorporated in Part B.I of the Investment Services Rules for Professional Investor Funds:

NEW The Scheme shall comply with the investment restrictions within six months from the launch of the Scheme or upon reaching a value equivalent to EUR 2,500,000 whichever is sooner. However, the Scheme will, provided it considers this to be in the best interest of its shareholders and that it observes the principle of risk spreading, not be required to comply with its investment restrictions upon reaching a value equivalent to EUR2,500,000 subject to it complying with such restrictions within a maximum of six months from launch. The Scheme shall take all reasonable steps to comply with the investment restrictions. The Custodian shall supervise the operation of the Scheme or the Manager to ensure that the Scheme complies with the investment restrictions.

NEW The Scheme may invest up to 100% of its assets in a Special Purpose Vehicle provided that the applicable investment, borrowing and leverage restrictions are satisfied at the level of the Special Purpose Vehicle.

NEW A Scheme may only enter into repurchase/reverse repurchase and stock lending or borrowing agreements:

- i. when in the opinion of the Scheme or its Manager, the entering into such agreements by the Scheme is appropriate and in the interest of investors in the Scheme, and entails an acceptable level of risk; and
- ii. in accordance with good market practice, which involves the provision of adequate collateral in accordance with good market practice to the satisfaction of the Scheme or its Manager.

NEW Investment by the Scheme in Financial Derivative Instruments as part of its investment policy in order to obtain exposure to underlying assets shall be without prejudice to the limits set out in these Rules which apply in the case of direct investments in such underlying assets. The exposure to the underlying assets should be calculated using the Commitment Approach indicated in Section 13 of Part B.II of the Investment Services Rules for Retail Collective Investment Schemes.

SLC 1.39 (amended)

Direct borrowing for investment purposes and leverage via the use of derivatives is restricted to 100% of NAV. The Scheme's exposure relating to derivative instruments is calculated taking into account:

- i. the current value of the underlying asset;
- ii. the counterparty risk;
- iii. future market movements; and
- iv. the time available to liquidate positions.

The Scheme's exposure relating to borrowing for investment purposes is the amount so borrowed.

The assessment of the Scheme's global exposure to derivative instruments should be assessed on the basis of the Value at Risk Approach or the Commitment Approach as set out in Section 13 of Part B.II of the Investment Services Rules for Retail Collective Investment Schemes.

Conditions included in Circular dated 21st May 2009:

- a. The Manager or (in the case of a self-managed scheme), the Scheme, must take reasonable steps to ensure that the Scheme is managed according to the risk spreading principle. In particular, the Scheme shall be required to adhere to the diversification requirements set out below. In the case of a Scheme investing in alternative assets, the MFSA may impose tailored investment restrictions.
- b. The Scheme may invest up to 20% of its total net assets in securities issued by the same body and up to 30% of its assets in money market instruments issued by the same body provided that :
 - i. the 20% / 30% limit set out in (b) above may be increased to a maximum of 100% in the case of securities and money market instruments issued or guaranteed by an OECD or EU/ EEA Member State, its local authorities or public international bodies of which one or more such States are members;
 - ii. the 20% / 30% limit set out in (b) above may be increased to a maximum of 35% in the case of securities and money market instruments guaranteed by a credit institution authorised in the EEA or which is subject to equivalent prudential requirements;
 - iii. the 20% limit set out in (b) above may be increased up to a maximum of 30% in the case of transferable securities traded in or dealt on a regulated market which operates regularly, is recognised and is open to the public.
- c. The Scheme may invest up to a maximum of ~~350%~~ of its total-net assets in deposits held with a single body.

- d. The Scheme is not subject to any investment restrictions with respect to investments in a single collective investment scheme provided that the underlying scheme is a UCITS or other open ended collective investment scheme subject to risk spreading requirements which are at least comparable to those applicable to the Scheme itself.
- e. The Scheme may invest up to a maximum of 30% of its total net assets in any single collective investment scheme which does not satisfy the conditions indicated in (d) above.
- f. Where the Scheme is a fund of hedge funds it shall invest in at least five hedge funds.
- g. Where the Scheme enters into OTC derivative transactions, it shall ensure that its exposure to a single counterparty is limited to 20% of its total net assets.

The exposure to one counterparty in an OTC derivative transaction may be reduced where the counterparty provides the scheme with acceptable collateral in accordance with good market practice to the satisfaction of the Scheme or its Manager.

The exposure per counterparty of an OTC derivative should not be measured on the basis of the notional value of the OTC derivative, but on the maximum potential loss incurred by the Scheme if the counterparty defaults.

The Scheme may net the mark-to-market value of its OTC derivative positions with the same counterparty, thus reducing the Scheme's exposure to its counterparty, provided that the Scheme has a contractual netting agreement with its counterparty which creates a single legal obligation such that, in the event of the counterparty's failure to perform owing to default, bankruptcy, liquidation or any similar circumstance, the Scheme would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions.

- h. The Scheme shall limit its aggregate maximum exposure (through securities, money market instrument, deposits and OTC derivatives transactions) to a single issuer/ counterparty to 40% of its total net assets.

Conditions for PIFS investing directly or indirectly in immovable property

(Please refer also to MFSA's Property Fund Policy found on the MFSA Website (www.mfsa.com.mt) in the Section entitled Securities/Collective Investment Schemes/Circulars/2007).

- i. The Scheme may invest up to a maximum of 25% of its total net assets directly or indirectly (through an SPV) in any one single immovable property. Subject to the Scheme being operated according to the risk-spreading principle, it will not be required to comply with this restriction before three years from its launch. For the purposes of this restriction, a property whose economic viability is linked to another property, is not considered as a separate item of property for this purpose.

- j. Where the Scheme invests solely in immovable property (rather than also in property funds and/or other securities), it should be exposed to not less than 5 different properties.

- k. The Scheme ~~shall not~~ may invest ~~more than 30%~~ 100% of its total net assets in any single property fund provided that such fund complies with the investment, borrowing and leverage conditions applicable to Professional Investor Funds targeted at Experienced Investors, established as property funds and which are set out in these Rules and in MFSA's Property Funds Policy.