

Sound Practice Guidelines for Administrators of Alternative Funds including Experienced Investor Funds in the Isle of Man

The Isle of Man Fund Management Association acts as a representative body for the Island's fund management and investment sector, with in excess of 50 member firms. The Association exists primarily to further the interests of member firms and its activities include providing focused training to member firms and representing the industry in respect of legal, regulatory and fiscal changes designed to encourage the growth and development of the sector on the Island. The Association also seeks to provide practical advice to member firms regarding emerging industry issues.

The purpose of these Sound Practice Guidelines is to provide member firms with guidance in relation to the services they provide in support of the establishment and ongoing administration of funds within the Isle of Man.

The Guidelines are not exhaustive and do not replace any statutory laws, regulations etc pertaining to Collective Investment Schemes incorporated, registered or administered within the Isle of Man. These Guidelines are additional to such laws and regulations and seek to codify minimum best practice.

These guidelines have been reviewed by the Isle of Man Financial Supervision Commission, who will use them as a benchmark for the supervision of the licenced parties involved.

1. Establishment of a fund

a) Professional Advice

Fund Managers establishing a Fund in the Isle of Man should seek legal and tax advice within the jurisdiction, prior to launch. A Fund Administrator is able to provide guidance as regards establishment and ongoing operations but it is generally not the responsibility of the Fund Administrator to provide legal, regulatory or taxation advice. All parties; the sponsor, the Fund's Directors, the Fund Manager, Administrator, lawyer and the auditing firm should ensure that all relevant issues are raised and covered during the establishment of a Fund so that the Fund meets all legal and regulatory requirements. The Auditors appointed to the Fund should be competent to carry out the function with regard to the nature, strategy and proposed activities of the Fund and they should carry a commensurate level of PI cover.

b) Due Diligence

Fund Administration is a regulated activity in all competent financial centres, primarily to provide a level of investor protection and to safeguard the reputation of the financial centre. Fund Administrators have a responsibility to ensure that they only accept business which they reasonably believe will not negatively impact these criteria. Before entering into detailed operational planning, a Fund Administrator should carry out adequate due diligence on all the parties who will be connected with the Fund. The promoters of the fund should be ascertained and due diligence should be performed upon them and their underlying shareholders. Although some promoters and sponsors are regulated in a competent jurisdiction, this alone should not be the only due diligence check performed. The Fund Sponsors, Investment Advisors and Fund Managers should be sufficiently competent to fulfil their

obligations to the fund and evidence of their competency should be obtained and retained by the Fund Administrator. Many Sponsors, Investment Advisors etc are licenced in a competent financial centre and rigorous checks should be made to establish that the parties are in good standing and are competent and sufficiently robust to carry out their obligations to the Fund.

c) Conflicts of Interest

In some cases the Sponsor and Investment Manager and others are related parties. Care should be taken to identify and ensure any reasonable potential conflicts of interest between all known related parties are fully explored at the outset and that the Offering Document (see below) clearly sets out all known related party issues.

d) Appointment of External Parties

The Fund Administrator should give consideration to the external parties appointed by the Fund Manager or Directors of the Fund. Auditors, Prime Brokers, Custodians, Valuation Agents, etc., should have a demonstrable track record in the type of business the Fund will transact and independence of external parties should also be considered, particularly any Valuation or Pricing Agents.

The Fund Manager or Directors should consider the appointment of an independent non-executive Director to the Fund. The Directors of a Fund have onerous duties imposed upon them by virtue of their appointment. There is a regulatory requirement that the proposed Directors understand their responsibilities and that they are satisfied that they are able to fulfil their obligations to the Fund prior to their acceptance of a Directorship. The Fund Administrator will sometimes appoint their own Director to the Board but this should be considered carefully in view of the onerous duties and the potential conflict of interests which may arise. All external appointments should be noted in the Material Documents of the Fund (see below).

e) Business and Marketing Plans

The name of the Fund should not be undesirable or misleading in terms of parentage or proposed activities. Sponsors and Fund Managers should have a business plan for the Fund. They should have an estimate of the likely initial value of the fund, minimum subscription levels and an indication of their prospective investor base. The Fund Administrator should, in its own interests, consider this on a general level and whether the indicated investor base is suitable for the type and structure of the proposed Fund. It should also, as far as is possible, consider if the subscriptions to be raised are likely to be sufficient to meet the investment criteria and costs of the Fund on an ongoing basis.

If the Fund is to be marketed through third parties, then the Fund Administrator should make the Directors, Fund Manager, Sponsor and Investment Manager aware of the need to ensure that all parties know and understand the limitations and restrictions imposed by the Constitutional and Material Documents of the Fund and the relevant laws and regulations in all the jurisdictions where the fund is or is to be promoted or marketed. Any agreements entered into between Fund Sponsors/Promoters and third parties should reflect all the limitations and restrictions imposed upon the Fund.

f) Constitutional and Material Documents

The Financial Supervision Act 1988 (as amended) at Section 31(1) defines the Constitutional Documents as follows:

“Documents constituting the scheme” includes in the case of a scheme which is an open ended investment company, the memorandum and articles of association of the company and any agreements between the company and the manager or trustee (if any) of the scheme.

For practical purposes the Material Documents of a Fund are usually considered to consist of:

Memorandum and Articles of Association (if structured as an open ended investment company) or

Trust Deed (if constituted as a Trust)

Fund Management Agreement

Investment Management Agreement

Investment Advisory Agreement

Fund Administration Agreement

Custodian/Trustee Agreement

Offering Memorandum

The preparation of the Material Documents of a Fund is of paramount importance. The Material Documents must be clear and unambiguous and contain all essential and relevant details, sufficient for a prospective investor to make informed decisions, at all times, regarding investment in the Fund.

A Fund Administrator should review in detail all operational aspects of the material documents prior to launch. They should ensure that all operational and practical aspects of the Fund are fully and correctly reflected within the material documents. Both the Fund Manager and Fund Administrator should ensure that there will be no conflict between the statements contained in the material documents and how they envisage the Fund will operate on an ongoing basis.

The Material Documents should set out fully the descriptions, functions and duties, separately, of each of the parties to the Fund, including the Sponsors, Managers, Administrators, Investment Advisors and any other parties such as Valuation Agents, Prime Brokers or Custodians.

2. Offering Memorandum (OM)

The OM, in addition to all items required by law and regulation, should contain the following information:

- a) A full description of the functions and duties of all parties and service providers to the fund. Any connections between parties which could lead to a conflict of independence (eg the Sponsor, the Investment Manager and/or the Valuation Agent) should be stated.

- b) Subscription, transfer and redemption procedures. Cut off times for redemption notice and deadlines for receipt of subscription application forms and monies should be clearly stated.
- c) Anti Money laundering (AML), 'Know Your Customer' (KYC) and all other regulatory issues. AML and KYC procedures should be set out clearly. The OM should accurately reflect all relevant regulatory issues and must not be in conflict with the regulations.
- d) Fees. The basis of the fees agreed between all parties contracted to the Fund should be stated so that the amount and nature of such charges can be understood. The mechanism used to calculate such fees must be stated as must the mechanism used to calculate any application of performance fee equalisation. In complex situations the Fund Manager or Fund Administrator may prepare worked examples of performance fees and agrees the examples in advance of launch to ensure that all parties understand how the fees will apply. All other expenses which will be the liability of the Fund, details of amortisations, deferments etc, should also be disclosed.

Commissions. Various types of commissions and trailer fees are often paid to external agents, financial advisers and brokers upon the introduction of investors into a Fund or upon the realisation of investment in the Fund by an introduced investor. These commissions are generally not paid by the Fund but the Fund Manager should be aware that the basis of such fees and commissions agreed between parties to the Fund and external parties should be contained in the OM or else notified to investors so that investors can understand the amount they have invested in the Fund after deductions made in respect of such fees and commissions.

- e) Valuation of assets. The OM should reflect how the assets held by the Fund are to be valued. The Fund Administrator is usually responsible for completing the Valuation and for the majority of assets the administrator will have access to independent pricing sources. In a situation where a Custodian Trustee is appointed by a Fund, it is the responsibility of the Trustee to ensure that the assets exist and are properly held. In many Alternative Funds a Custodian Trustee is not appointed and assets are sometimes held with Prime Brokers. Where there is no Custodian Trustee, the Fund Administrator should ensure that the Fund Manager is aware its responsibilities with regard to the underlying assets of the Fund.

Care must be taken when it is envisaged that OTC, derivatives, synthetics or other hard to value assets are to be acquired by the Fund. In these circumstances, where it is difficult to obtain independent verification of prices, the OM should clearly set out who will be providing the prices (ie will an independent valuation agent be employed or specific valuation technology utilised) and who of the parties involved in the Fund (eg Sponsors, Fund Managers, Directors) will be responsible for the efficacy of the prices included in the valuation. Where it is not possible to obtain an independent valuation of an asset, then this fact should be stated in the OM and be contained specifically in the risk warnings section. Where a price of an asset can only be

determined by 'fair value' methodology, then this should also be stated. In some circumstances, for example when the investment strategies of a fund are necessarily wide and complex, to take advantage of future situations, a 'Pricing Policy' document may be prepared and updated as and when situations arise. In this event the OM should state who will be agreeing the Pricing Policy and set out the circumstances in which the Pricing Policy will be amended and adopted by the fund.

- f) **Liaising with Investors.** The OM should set out how communications will be conducted with investors, including details with regard to subscriptions, transfers and redemptions. It should also detail how subscription monies are to be paid and how redemption proceeds and dividends, equalisation payments etc are distributed to the investor. The manner in which confirmations or contract notes for subscriptions and redemptions are issued and the distribution of reports and accounts should also be included. The OM should specify deadlines for the completion and distribution of reports and particularly the audited financial statements (which should be within the time frames permitted by law and regulation).

It is of paramount importance that audited financial statements are completed and distributed to investors within the specified deadlines. If a delay occurs the Fund Manager must have a mechanism whereby all interested parties including the relevant regulatory bodies are notified immediately. A continuing delay in the completion of audited financial statements could be construed as a serious breach of a fund's duty to the investors, dependent upon the reason for such delay. The delayed pricing of an asset within the fund, for example, could compromise the valuation of the fund on an ongoing basis. A graduated approach in dealing with continuing delays is necessary so that all parties including, in particular, the regulatory bodies and the investors, are advised of the circumstances of the delay and kept informed on a regular basis until the audited financial statements are completed and distributed. The Financial Supervision Commission has a notification procedure to be followed by Fund Managers and/or Fund Administrators where the distribution of Audited Financial Statements are delayed longer than 10 days after the despatch date set within the Constitutional and Material Documents.

3. Administration Agreement

The Administration Agreement will reflect the contractual basis on which the Fund has appointed the Fund Administrator and set out in detail the various duties which are to be undertaken. In addition to all items required by law and regulation, the Administration Agreement should contain the following information:

1. Details of the services to be supplied by the Fund Administrator, for example, NAV calculation, preparation of financial reports and accounts, registrar and transfer agency functions, trade settlement support etc.
2. The basis of the fees and the expenses which are to be charged by the Fund Administrator to the Fund, including how the fees are to be calculated, accrued and paid.

3. Liability and Indemnity clauses setting out the circumstances where the Fund Administrator may or may not be liable for any loss incurred as a result of the performance or non performance of its duties
4. Termination clause setting out the circumstances, remedies and notice period by which any or all parties to the agreement may terminate the agreement. Termination fees and default provisions should be stated. The notice period should normally be not less than three months and the clause should contain provisions for the notification of intention of termination to investors and all relevant parties, including the relevant regulatory bodies.

There may be benefits in entering into a Service Level Agreement between the Administrator and the Fund or Fund Manager. If there is no Service Level Agreement then the Administration Agreement should quantify the service levels.

4. Communication with Investors

In communicating with the Investor the Fund Administrator is generally representing the Fund and communication should be full, fair and timely. In particular, the processing of investor dealing should adhere strictly to the terms set out in the OM and confirmations should be despatched without delay. If the Fund Administrator has been tasked with despatching NAV's reports and/or accounts then every effort should be made to ensure that they are issued on a timely basis. Where appropriate a reason for any delay should be communicated to the investor.

Fund Administrators should maintain complaint and error reports and the details should be reported promptly to the Fund, Fund Manager and regulatory bodies as appropriate.

5. Anti Money Laundering

Anti Money Laundering legislation applies to Fund Administrators and there is extensive and comprehensive regulation and guidance issued by the regulatory bodies covering this topic. It must be stressed that complete adherence to the regulations and guidelines is of the utmost importance. Fund Administrators and their staff must be aware of the regulations in this regard.

6. Net Asset Valuation (NAV) Calculation

The calculation of NAV is the core activity of the Fund Administrator. Methodology, and frequency will be set out in the OM and the Administration Agreement. It is of paramount importance that the NAV is produced accurately and on a timely basis. The NAV is used by the Fund or the Fund Manager to determine the price at which investors subscribe for or redeem shares or units in the Fund.

In order to calculate the NAV, the Fund Administrator will maintain accurate details of the Fund's assets, usually including the trade history. Up to date prices, obtained from an independent source where possible, will be applied to those assets to calculate their value. Reconciliations between the Fund Administrator's records and statements

from Custodians, Prime Brokers and other parties should be performed on a regular basis as a check that the Fund Administrator's records are accurate and that any counterparty or out of market risk can be identified at an early stage. To complete the NAV the Fund Administrator will calculate all fees and expenses and provide for these against the assets of the Fund to produce a final NAV. Where lending and or gearing is in use, a Fund may also produce a GAV (Gross Asset Valuation).

There are five stages in the calculation of NAV:

- a) **Trade Capture.** The volume of trading activity can vary significantly dependent upon the strategy of the Fund. In some cases hedge funds may trade hundreds of transactions intra day via their Prime Brokers. In other cases, say Venture Capital or Event Driven funds, trades may be as low as one or two per month.

Where trading activity is high, it is important that trading activity is reflected in the Funds books, by the Fund Administrator as soon as possible. Prime Brokers will usually send electronic trade files on a daily basis and it is desirable that Fund Administrators obtain this information from the Prime Brokers direct and confirm it, if necessary, to the Fund Manager, rather than relying upon the Fund Manager's records alone. Generally, trading information should be supplied directly from the trader (Prime Broker, Counterparty, Clearing Broker, CTA, CPO, etc) to the Fund Administrator. Information feeds from the Fund Manager, Sponsor or Investment Advisor, should not be relied upon as a sole source of trading information. Trade capture carries high operational risk and the Fund Administrator's systems and controls should be robust, particularly any manual interfaces. If appropriate, tri-party reconciliations should be maintained up to date and performed at frequencies appropriate to the level of trading activity, to ensure accurate NAV calculation.

- b) **Security Pricing.** As trading strategies become more complex, it is vital that the risks attached to security pricing are carefully considered at the outset, prior to the launch of the fund or on commencement of a new trading strategy. In its most complex form, security pricing requires high quality, robust data feeds, price validation systems and highly experienced staff. It is also important that consideration be given to the independence of pricing at the outset, in order to deal with situations where it may not be possible to obtain independent verification, so that a clear pricing policy is agreed between all relevant parties and that this is communicated clearly, in the OM, to investors. Where independence of pricing is an issue, then the Fund Administrator should be in a position to assess that the price provided is reasonable. If appropriate, consideration should be given to determining a procedure for resolving disagreements, prior to launch, between the parties, including the auditor, should a dispute arise on the pricing of a 'hard to value' asset.

The majority of the challenges in respect of security pricing involve securities and assets which are not traded over a recognised exchange. Even so, exchange traded securities do have an element of risk and Fund Administrators should ensure that, the prices they have obtained are validated

to acceptable tolerances, that stale prices remain valid and that there is sufficient liquidity in the market and the asset such that a trade could reasonably be expected to occur at that price. Care should be taken in certain funds where the strategy of the fund is to acquire sufficient stock of one entity such that a sale of the entire holding would in itself impact the price. Care should also be exercised where assets are introduced into the fund *in specie* or in any other circumstances where the trade is not 'at arms length'. Independent assessment should be considered to ensure that the value attributed to such trades is a 'fair value' and not detrimental to the existing investors in the fund (unless the issue is specifically documented in the OM).

Fixed Income Securities can be problematic where they are thinly traded or not quoted on a recognised exchange.

OTC, Unquoted and Derivative Assets. This is now such a wide and varied subject within the Funds Industry and it is recommended that Fund Administrators who take on the administration of Funds which are likely to invest in such assets do so only when they are satisfied that they have robust, tested valuation procedures and adequate resource to fulfil this function. Security pricing in this area is highly skilled and the control of this function should be central to the Administrator's core operations. Fund Administrators should, where possible, be employing common pricing procedures across all the Funds they administer and Funds should price assets using consistent methods from NAV to NAV.

In accumulating and collecting prices, the Fund Administrator should obtain a counterparty valuation of the position and have independent capacity to substantiate the counterparty's valuation either internally or by means of a third party specialist. Consideration should be given to the accuracy of the counterparty's pricing model, in that the valuation is current, assumptions used are valid and that the valuation is sufficiently independent of any vested interest the counterparty may have in the price quoted.

If there are circumstances where a Fund Administrator has to rely upon a price of an asset determined by the Fund Manager or other non independent party, the Fund Administrator should ensure that the obligation, to value the asset of the Fund based upon a non independent source, is fully and clearly covered in the OM, including details of the pricing model to be used.

- c) **Reconciliations.** The Fund Administrator's record of assets should be reconciled with those of all the counterparties, including Prime Brokers and Custodians. They should also be reconciled with the records of the Fund Manager and Investment Manager where necessary. Any material difference in the reconciliations must be resolved prior to the issuance of a final NAV.
- d) **Expense calculation.** The Fund Administrator should accrue all fixed and variable expenses including management, administration, advisory, custodial and performance fees and audit fees, amortised establishment costs, legal and directors fees. It is important to ensure that performance fees are correctly

calculated in accordance with the methods which will have been outlined in the OM as they can have a material effect upon the calculation of the NAV.

- e) **NAV Calculation and Reporting.** The final step is to calculate the NAV per share taking into account any different classes of shares in issue and any equalisation allocations. The NAV per share will usually be calculated by the Fund Administrator but should be agreed by the Fund and or Investment Manager prior to release of prices and or the distribution of the NAV to investors.

7. Investment Monitoring

Alternative Funds which in the main are not ‘authorised’ for sale to the general public, may voluntarily adopt specific investment restrictions in varying degrees of complexity dependent upon the nature and strategy of the fund. These ‘restrictions’ and/or ‘tolerances’ can be particularly flexible, complex and/or extremely specific as regards borrowing, leverage, short exposure, currency or other net hedging, performance criteria, concentration of risk, convergence criteria etc. The responsibility for monitoring the investment parameters set by the Fund should be agreed at the outset in terms of how this responsibility is to be undertaken, ensuring that the accounting and record keeping systems are adequate to perform the function and that sufficient information will be made available to the party responsible for the monitoring. The party responsible for the performance of this function should be specified in the Fund’s Constitutional and Material Documents. The Fund Administrator should ensure that the party who is made responsible for the monitoring process is fully aware of the requirement to ensure that any investment parameters and/or restrictions which may be contained within the Fund’s Constitutional and/or Material Documents are not breached and that sufficient information will be provided to that party to undertake the function adequately.

8. Marketing and Promotion

Historically, investment into Alternative Assets including hedge funds was the domain of large investment institutions and very high net worth individuals. The formation of hedge funds tended to be on specialist grounds, often for specific purposes and with few investors. Hedge funds generally did not need to market themselves and little consideration was given to promotion through public offering documents or promotional material. Consequently there was little need for the transparency and reporting requirements associated with long only public funds.

In recent times this has changed and Alternative Asset Funds are becoming more mainstream. They are now being promoted within the industry to a wider institutional base, including pension and superannuation funds, investment companies who are forming fund of funds and multi manager funds and to professional and experienced investors where they are utilised as non correlated asset classes within diverse investment management portfolios.

The risk profiles of Alternative Asset Funds are however vastly more complex than those of a “long only” public fund. The risk to the investor of losses is not necessarily greater than the risks associated with long only public funds but the complex and

varying risk profiles of Alternative Asset Funds are inherently of greater potential impact to an investor. All potential investors into Alternative Asset Funds must be made aware of the risks and once it has been recognised that a fund of this nature is to be marketed, albeit in a strictly limited manner, in keeping with the nature of a non regulated fund, all parties to the Fund, at the outset, should ensure that all the risks associated with the Fund have been fully considered and that they are fully disclosed in the OM. Dependent upon the marketing strategy of the Fund, all parties should consider the prominence of the risk profile within the OM. Where the Fund is to be promoted to investors who are individuals, consideration should be given to including the risk profiles both in the detailed text of the OM and highlighted in a separate section so that all 'risk warnings' are clearly stated together.

Prior to launch, the Fund Administrator should carefully consider whether the adequacy of the risk profiles and warnings contained in the OM are commensurate with the marketing strategy of the Fund. All parties to the Fund should be reasonably concerned that an investor is able to read and understand not only the contents of the OM but specifically the risk warnings contained within it. One way of ensuring this is to have reference to the risk warnings contained in the subscription document which forms part of the OM. The investor should be required to sign the subscription document so that it is clear that the risk warnings have been read and understood. The Fund Administrator should only process subscriptions applied for using the subscription form contained within the OM.

Certain Funds in the Isle of Man, including Experienced Investor Funds may only be promoted to a category of investors as prescribed by the regulations pertaining thereto. All parties to the fund should be aware of this prior to launch and the prescribed investor declaration should be incorporated into the OM. Fund Administrators should ensure that the declaration has been completed by the investor prior to subscribing into the Fund. A proposed declaration is appended to this document.

The OM should be considered by all parties as the primary marketing document of the Fund and any other form of marketing, produced by either another party to the Fund or by any third party, should not contain any material statements which are not contained within the OM. No invitation to invest should be contained within any literature other than the OM

All parties to the Fund, including any third party promoters, Financial Advisors etc., should be made aware of the legal and regulatory requirements with regard to marketing and promotion, to ensure that the Fund is only marketed in a manner likely to attract suitable investors, given the nature of the assets,

Consideration should be given to obtaining periodic confirmations from the Sponsor, Investment Advisor and/or other agents connected with the Fund confirming that they understand the restrictions imposed upon them by the OM, law and regulation and that any marketing literature issued is in accordance with these guidelines. This is particularly relevant where additional third parties are appointed to market the Fund subsequent to the launch of the Fund.

.These guidance notes have been prepared with reference to AIMA Guide to Sound Practices for Hedge Fund Administrators, the Managed Funds Association's Sound Practices for Hedge Fund Managers and from submissions made by professional bodies to the FSA in respect of the intention to introduce a measure of regulation of Hedge Funds in the UK. No account has been taken of the EU UCITS Directives nor the registration process required by the SEC in the USA in respect of Funds with USA investors. These notes are not exhaustive and should not be used in place of relevant laws and regulations. As Sound Practice guidelines, they are in parts necessarily subjective. As such, no legal reliance should be placed upon them nor on any omissions therefrom.