

Chapter 5

Investment and borrowing powers

5.7 Investment powers and borrowing limits for NURS operating as FAIFs

Application

5.7.1

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

Purpose

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

Applicable rules in COLL 5.6

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

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

Investment powers: general

5.7.4 **R**

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

Spread: general

5.7.5 **R** (1) This *rule* does not apply in respect of a *transferable security* or an *approved money-market instrument* to which **COLL 5.6.8 R** (Spread: government and public securities) applies.

- (2) Not more than 20% in value of the *scheme property* is to consist of *deposits* with a single body.
- (3) Not more than 10% in value of the *scheme property* is to consist of *transferable securities* or *approved money-market instruments* issued by any single body subject to ■ COLL 5.6.23 R (Schemes replicating an index).
- (4) The limit of 10% in (3) is raised to 25% in value of the *scheme property* in respect of *covered bonds*.
- (5) In applying (3) *certificates representing certain securities* are to be treated as equivalent to the underlying *security*.
- (6) The exposure to any one counterparty in an *OTC derivative* transaction must not exceed 10% in value of the *scheme*.
- (7) Except for a feeder *scheme* which (in respect of investment in *units* in *collective investment schemes*) is *dedicated* to the *units* of a master *scheme*, not more than 35% in value of the *scheme* is to consist of the *units* of any one *scheme*.
- (8) For the purpose of calculating the limit in (6), the exposure in respect of an *OTC derivative* may be reduced to the extent that collateral is held in respect of it if the collateral meets each of the conditions specified in (9).
- (9) The conditions referred to in (8) are that the collateral:
 - (a) is marked-to-market on a daily basis and exceeds the value of the amount at risk;
 - (b) is exposed only to negligible risks (e.g. government bonds of first credit rating or cash) and is liquid;
 - (c) is held by a third party custodian not related to the provider or is legally secured from the consequences of a failure of a related party; and
 - (d) can be fully enforced by the *non-UCITS retail scheme* operating as a *FAIF* at any time.
- (10) For the purpose of calculating the limit in (6), *OTC derivative* positions with the same counterparty may be netted provided that the netting procedures:
 - (a) comply with the conditions set out in Part Three, Title II, Chapter 6, Section 7(Contractual netting (Contracts for novation and other netting agreements)) of the *UK CRR* and
 - (b) are based on legally binding agreements.
- (11) In applying this *rule*, all *derivatives* transactions are deemed to be free of counterparty risk if they are performed on an exchange where the *clearing house* meets each of the following conditions:
 - (a) it is backed by an appropriate performance guarantee; and
 - (b) it is characterised by a daily mark-to-market valuation of the *derivative* positions and an at least daily margining.
- (12) For the purposes of this *rule* a single body is:

- (a) in relation to *transferable securities* and money market instruments, the *person* by whom they are issued; and
- (b) in relation to *deposits*, the *person* with whom they are placed.

Guidance on spread: general

5.7.6

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

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Investment in collective investment schemes

5.7.7

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A *non-UCITS retail scheme* operating as a *FAIF* must not invest in *units* in a *collective investment scheme* (second *scheme*) unless the second *scheme* is a *scheme* which satisfies the criteria in ■ COLL 5.6.10 R (1) (a) to ■ (d) or meets each of the requirements at (1) to (4):

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

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

Due diligence requirements

5.7.9 **R** (1) A *non-UCITS retail scheme* operating as a *FAIF* must not invest in *units* in schemes in ■ COLL 5.7.7R (1) to ■ (3) ('*second schemes*') unless the *authorised fund manager* has carried out appropriate due diligence on each of the *second schemes* and:

- (a) is satisfied, on reasonable grounds and after making all reasonable enquiries, that each of the *second schemes* complies with relevant legal and regulatory requirements;
- (b) has taken reasonable care to determine that:
 - (i) the property of each of the *second schemes* is held in safekeeping by a third party, which is subject to prudential regulation and independent of the investment manager of the *second scheme*;
 - (ii) the calculation of the net asset value of each of the *second schemes* and the maintenance of their accounting records is segregated from the investment management function; and
 - (iii) each of the *second schemes* is regularly audited by an independent auditor in accordance with international standards on auditing.

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

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

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

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

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

- (1) whether the experience, expertise, qualifications and professional standing of the second *scheme's* investment manager is adequate for the type and complexity of the second *scheme*;
- (2) the adequacy of the regulatory, legal and accounting regimes applicable to the second *scheme* and its investment manager;
- (3) whether the second *scheme*, its investment manager and administrator have complied with their legal and regulatory obligations, including but not limited to an evaluation of the investment manager's written policies with respect to such compliance;
- (4) the extent to which the second *scheme's* investment manager adheres to guidance and codes which amount to good practice in the industry;
- (5) the adequacy of the second *scheme's* systems, controls, governance, accounting, administration, business continuity, disaster recovery, safekeeping, custody and trading and execution arrangements;
- (6) the extent to which the property of the second *scheme* may be rehypothecated and the potential impact of such rehypothecation on the *non-UCITS retail scheme* operating as a *FAIF*;
- (7) the adequacy of the second *scheme's* risk management process, in particular:
 - (a) the methodology by which risk is measured and its practical adequacy in the light of the limitations inherent in risk measures (such as value at risk), including where appropriate, reference to market risk, credit risk (including counterparty credit risk), liquidity risk, operational risk and outsourcing risk;
 - (b) the extent to which the second *scheme's* investment manager carries out stress testing and backtesting, to determine how potential changes in market conditions could impact on the value of the second *scheme's* portfolio;
 - (c) the reporting, escalation and review processes within the second *scheme's* governance structure;
 - (d) the manner in which risks arising from services provided by third parties are managed, including where those third parties provide prime brokerage, administration, auditing, valuation, risk monitoring, business continuity and disaster recovery services; and
 - (e) the management of key person risk;
- (8) the adequacy of the second *scheme's* investment strategy and trading philosophy;
- (9) the implications of currency convertibility (if any);
- (10) whether the second *scheme* produces a valuation that is sufficiently accurate for the *authorised fund manager* to be reasonably satisfied that the price of the *FAIF's units* can be calculated in accordance with [COLL 6.3 \(Valuation and pricing\)](#), including but not limited to an assessment of:

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

Non-UCITS retail schemes that are umbrellas with FAIF sub-funds

5.7.12

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In relation to a *non-UCITS retail scheme* which is an *umbrella* comprised of *sub-funds* which are:

(1) *FAIFs*; or

(2) a mixture of *FAIFs* and standard *non-UCITS retail schemes*;

the provisions in this section apply to each *sub-fund* operating as a *FAIF* as they would to a separate *scheme*.