Thematic Review - 2015

Alternative Custody Arrangements of Open Ended Collective Investment Schemes

Guernsey Financial Services Commission

Contents

Glossary of Terms

In this Thematic Review:

Collective Investment Scheme means any arrangement such as is identified as described in paragraph 1 of Schedule 1 to the Law that is declared by the Commission to be Open-Ended Authorised or Registered;

Law means the Protection of Investors (Bailiwick of Guernsey) Law, 1987, as amended;

Manager means:

(a) the designated administrator/designated manager or

(b) where there is a principal manager and a designated administrator/designated manager each such person or

(c) where there is more than one designated administrator/designated manager each such person;

Rules means the Rules issued under the Law, from time to time, by the Commission in connection with Collective Investment Schemes as defined above; and

Custodian means:

- a person designated as such by the Commission for the purposes of the Law (as designated in the Commission's authorisation or registration of the scheme under Section 8 of the Law),
- a designated trustee in the case of a unit trust scheme
- a designated custodian in the case of an authorised or registered scheme other than a unit trust scheme

1: Introduction

The Investment Supervision and Policy Division sent out a thematic questionnaire to the Boards of all Class B and Class Q collective investment schemes authorised as at 8 October 2015.

By way of background the Commission has adopted a flexible approach to the application of the Authorised Collective Investment Schemes (Class B) Rules, 2013 ("the Class B Rules") and the Collective Investment Schemes (Qualifying Professional Investors Funds) (Class Q) Rules ("the Class Q Rules") for schemes with certain asset classes and investor types. The review looked at those instances in more detail, in particular those waivers issued in respect of custody arrangements, for example where prime brokers or other non-Guernsey custodians have been appointed.

In order to issue such waivers, the Commission has relied on attestations made by parties to the schemes in respect of the oversight of the alternative custodian and the duties of oversight of the scheme's manager that the rules require. The Commission sought to ascertain that the waivers issued work in practice and that there is effective oversight such that there is no increased risk to investors in each of the schemes.

One of the main issues that arose from the thematic was the level of oversight the scheme applies to the hypothecation of its assets. Three stated that they did not allow for hypothecation, four stated that they allowed it but the prime broker did not currently consider such asset types for hypothecation and five stated that they undertook it, of which only two claimed to monitor it on an intraday basis.

2. Methodology

The Commission developed a questionnaire that only schemes with alternative custody arrangements were required to respond to. The questionnaire requested details of each specific rule derogation as it applied to the scheme, whether the firm felt it remained fit for purpose and then included some more granular queries on the oversight process. Prior to releasing the questionnaire the Commission sought the views of Mike de Haaff, a consultant to the Guernsey Investment Fund Association on the content and the questionnaire was adapted based on his feedback.

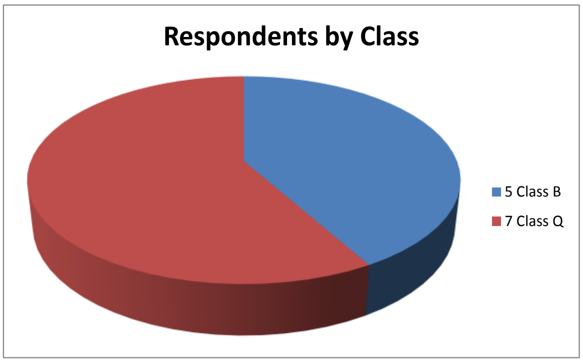
The questionnaire was sent to all designated managers of open ended schemes with instructions that the questionnaire should be passed to each fund board for consideration. It was made clear that only schemes with alternative custody arrangements need respond and we did not request nil returns. The questionnaire was sent out on 8 October 2015 and a response was requested by 13 November 2015.

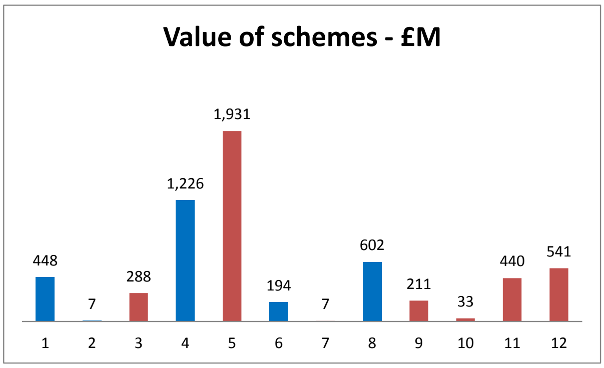
It was originally intended that a small number of onsite visits would be undertaken based upon the results of the questionnaire however, Due to the nature of the Commission's findings follow up enquiries were able to be picked up through correspondence and meetings.

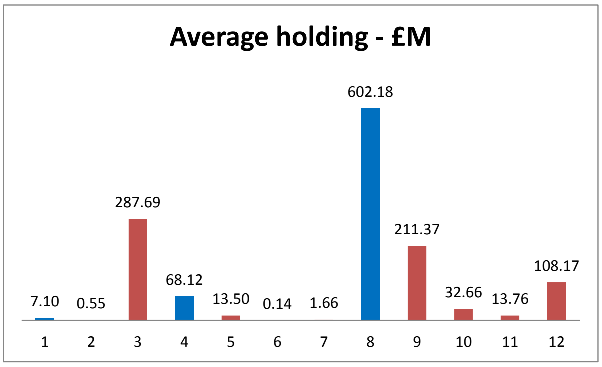
The questionnaire was sent to twenty-six designated managers encompassing 171 open ended schemes. The Commission's records show that twenty-two derogations covering custody arrangements have been issued and remain current.

3: Findings

Responses were received on behalf of twelve schemes. Each scheme provided details of net assets and number of shareholders in order that a rough average investment calculation could be undertaken. It was concluded that no scheme which responded to the thematic could be considered a retail scheme based on this information.







Three schemes had been issued with a "blanket" derogation of the Class B Rules as they apply to the custodian. The rest of the respondents had been issued with a more tailored modification. All respondents considered that the derogation issued to each scheme remained fit for purpose.

The questionnaire asked whether schemes allow rehypothecation of assets and if so how it is monitored. Rehypothecation is the practice by banks and brokers of using, for their own purpose assets that have been posted as collateral for their clients. Schemes that allow the prime brokers to rehypothecate assets may be compensated by a one off fee each time or by a rebate or lowered fee.

Of the twelve responses nine stated that rehypothecation was permitted within the scheme documents but only five stated that it was currently being conducted by the prime brokers. Of those five schemes, three either do not monitor the rehypothecation or it was not clear how it is monitored.

The Commission noted the following examples of good and poor practice in monitoring rehypothecation of scheme assets.

Examples of good practice:

The risk management framework focusses on credit risk, default probabilities and market news that may adversely impact the prime brokers. Monitoring takes place daily and is summarised weekly. Reports are generated internally as well as by the Group Risk function. Reports are provided to the Fund Board on a quarterly basis which detail the current exposure and credit monitoring for each counterparty.

There are a number of reports received daily from the prime brokers, ranging from collateral statements to deal confirmations and positions reconciliations and valuations. The books and records are reconciled on a daily basis with the prime brokers. Any reconciling items are managed on an exceptions basis.

The prime brokerage agreement does allow for hypothecation, but this is not currently conducted on those assets held at the Prime Broker ("PB") as a custodian; the PB has indicated that they do not currently consider such asset types for hypothecation.

An online reporting tool is used on an intraday basis by the Investment Manager to monitor portfolio activity such as cash, margins and trades at the Prime Broker. This would show (re)hypothecation if this were to occur.

The above examples appear to demonstrate that the Board has considered various types of potential risks and has a pro-active and timely approach to monitoring those.

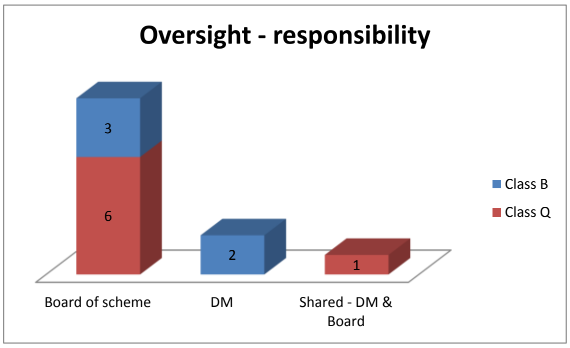
An example of poor practice:

Subject to any specific provisions of the relevant Supplemental Offering Memorandum, the Directors may exercise all the powers of the Scheme to borrow money and hypothecate, mortgage, charge or pledge the assets, of the Scheme. Standard terms for a margin account include collateralisation of assets to permit dealing, as dictated by the broker's terms. This is monitored by the Board, which considers this matter at quarterly board meetings, where assets are noted and service providers are reviewed. A statement of assets and portfolio valuation papers form part of the Board papers. On an annual basis all assets held by the Scheme are subject to external audit. Custodian oversight and site visit review also forms part of the risk management framework.

This example appears to demonstrate a more generic and less risk based approach and hypothecation does not appear to be monitored on an ongoing basis. There is also a reliance on an annual audit. Whilst there is some monitoring of risk, this approach is more akin to the minimum the Commission would expect of the Boards of all collective investment schemes and does not appear to reflect the unique nature of the custody arrangements.

The Commission’s findings did not differ significantly from those identified by the FCA in its Thematic Review of Hedge Funds in July 2015.

The questionnaire queried which parties were responsible for oversight of the designated manager (where the custodian's fiduciary role had been modified) and the party responsible for the oversight of the custodian to ensure safekeeping of customer assets. More details of the risk management framework were then requested.



The Commission found a mix of parties responsible for the oversight but the majority of respondents stated that the Board of the Scheme retained responsibility for oversight which was as expected.

The detail of the risk management framework varied within the respondents from the intra-day use of online reporting tools and the daily monitoring of markets news, credit risk and default probabilities of the prime brokers to quarterly Board reviews of custody statements and compliance reports. One firm also undertakes monthly conference calls with its sub-custodians.

Overall the results were as expected and whilst there is clearly a sliding scale of oversight the team were satisfied that all respondents had some kind of framework in place, particularly as each scheme reviewed would have a unique set of risks attached to it.

4: Conclusion

The Commission took some comfort from the fact that all firms were undertaking some kind of oversight of service providers where modifications of the rules as they apply to custodians were in place. We would encourage firms to review their own practices in light of the findings above and consider whether their own risk management frameworks could be enhanced in line with the examples of good practice given.

Any firms considering requesting a modification of the rules as they apply to custodians should consider the foregoing and will be requested to provide details of their proposed risk management framework.

In order to inform future thematics the Commission wrote to designated administrators that act for schemes that did not respond but the Commission's records suggested they should have and those responses are being considered. It should be noted that whilst responses to this thematic were made on a voluntary basis future thematics may not be voluntary.

The Commission would like to take this opportunity to thank all firms who did respond to the questionnaire.