



Jersey Financial Services Commission

Chief Executives (or equivalent)
of all persons registered to conduct
fund services business under the Financial
Services (Jersey) Law 1998

6 April 2011

Dear Sir or Madam

Jersey Financial Services Commission (the "Commission") 2010 Overview of the Securities Division, Funds & Priorities for 2011

This letter summarises the results of our fund supervision visits made over the last year, the key findings, and our themes for supervisory visits in the coming year. It also addresses the major objectives facing the funds section of the Securities Division and the main issues we are seeking to deal with in 2011.

Key findings from 2010

The Funds Supervision Team (the "**Team**") undertook 32 on-site visits to regulated entities in 2010. A key aim of the visit programme is to facilitate collaboration between Industry and the Commission resulting in clearer practical guidance being issued where appropriate. Each examination results in a report for the business in question based on information obtained during the examination. Three of the examinations conducted during 2010 were themed visits, the theme being valuation of fund assets which was continued over from 2009.

Overall, the themed examinations in 2009 and 2010 recorded a limited number of findings in respect of fund valuations. The most common finding was the lack of evidence to demonstrate that the boards of the funds were considering and monitoring valuations, and the performance of the fund generally.

The Team was also interested in reviewing the practical measures taken by Industry to demonstrate compliance with the Fund Services Business Codes of Practice (the "**FSB Codes**"), and to identify areas of the FSB Codes where additional guidance or clarification may be desirable.



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Common themes emerging from last year's examination programme include: a lack of appropriate due diligence on promoters and other parties in relation to new funds; lack of appropriate due diligence on investors with attendant risk ratings; a failure to demonstrate proper oversight by the board in respect of its own activities, as well as compliance and outsourcing arrangements. The same failings were found in relation to managed entities.

The Team continued to manage a number of forensic investigations in conjunction with the Commission's Enforcement Division.

The Division has dealt with a significant number of fund revocations and mergers over the past year. In addition, 47 FSB registrations were surrendered or revoked by request partly due to rationalisations but partly due also to market conditions. A further four applications were withdrawn before a certificate was issued.

2011 On-site Examinations

During 2011 the Commission's themed examinations will look at due diligence, including take on procedures generally, due diligence on the investment manager under the Jersey Expert Fund regime, due diligence when outsourcing or delegating functions, and due diligence in respect of AML/CFT. The team may decide to consider all these areas or alternatively just to concentrate on one or two aspects. Moreover, while half of the planned examinations will be focussed visits and one-third themed visits, the Funds Supervision Team will, where appropriate, cover wider aspects of a registered person's business operations.

The Team intends reducing the period between the on-site examination and the final report. To that end examination findings will be based on the facts presented to the Commission prior to and during the on-site examination itself. We will no longer consider material presented to us subsequently in relation to the examination report, however such material will be taken into account for the purposes of the remediation plan. Furthermore, the Team will continue to provide the relevant business with a draft examination report, however we shall only consider comments on the draft relating to our reporting of the facts as they are presented to us during the examination.



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Operations and Policy

In November the Commission launched the facility to file statistics on-line making the process of statistics reporting by Industry quicker and more straightforward for all parties.

For the first time the Commission hosted a meeting of the Enlarged Contact Group, an informal association of international securities regulators, over three days. The Division also presented an all day seminar on funds at the Hotel de France.

Consideration has been given to proposed changes to the recognized fund rules as well as the creation of new categories of recognized fund, and meetings have been held with the UK Financial Services Authority.

The Funds Authorisation User Group also met during the year to discuss issues arising during the funds authorisation process, and changes to procedures were proposed and implemented.

A number of funds policy developments were progressed. Changes to the Outsourcing Policy were agreed and will now include guidance on delegation by fund functionaries. The revised Policy will be published shortly on the Commission's website.

We continue to be actively engaged in the review of the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions ("IOSCO"), of which Jersey is a full member. Following the economic crisis, IOSCO is amending its Objectives and Principles in certain key areas such as the specific inclusion of hedge funds, and a tightening of the key principles applicable to all funds generally. The Principles are seen as a cornerstone of international securities regulation and are generally regarded as the benchmark by which compliance with international standards is measured.

The amendments are close to conclusion and will be presented to the full membership of IOSCO at its annual general meeting in April, following which there will be a further period of consultation within the membership. The Commission has taken an active role in these discussions and is represented on the Implementation Task Force considering the Principles as a whole. We also sit on the Task Force's sub-group looking at the specific Principles in respect of funds. The outcome of the consultation exercise will have an important bearing on the final form of our own draft Codes of Practice for Certified Funds (the "Funds Codes") and the new Certified Funds Prospectuses Order 201-.



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We are also actively monitoring developments concerning the EU's Directive on Alternative Investment Fund Managers ("AIFMD") which has now been passed in final form. Industry is also engaged in closely monitoring developments in this area and we are participating in Industry's AIFMD Project Oversight Board. Again, the fine print of the Directive may shape future development of the FSB Codes and the Funds Codes.

We are however acutely aware that the passing of the AIFMD does not in itself signify matters are anywhere near settled. Much will depend on how the Directive is implemented, particularly with reference to the third country provisions and their application to Jersey and other centres outside the EU. In our view, passing the Directive is very much the beginning of the process rather than its conclusion, and considerable work lies ahead in both the technical and political arenas.

Discussions continue on updating the Collective Investment Funds (Recognized Funds) (Rules) (Jersey) Order 2003 in consultation with Industry and the other designated territories. The Commission is involved in meetings with the JFA working party together with representatives from the Law Draftsman's Office and Economic Development. The latest proposals were formally submitted to the UK Financial Services Authority and HM Treasury for consideration in November. Since then meetings have been held with the FSA on the future of the Recognized Fund regime following the finalization of the AIFMD. The situation is being kept under review pending publication of the Level II requirements by the EU in respect of the AIFMD.

Progress continues with merging the two Orders dealing with prospectuses for Jersey certified funds, namely the Collective Investment Funds (Unclassified Funds) (Prospectuses) (Jersey) Order 1995 and the Companies (General Provisions) (Jersey) Order 2002. The intention is to have just one Prospectus Order, called the Collective Investment Funds (Certified Funds - Prospectuses) (Jersey) Order 201-, that will apply to all Jersey certified funds, including funds established as limited partnerships and closed-ended unit trusts. In future, the Companies (General Provisions) (Jersey) Order 2002 will apply only to non-fund public companies, and the Collective Investment Funds (Unclassified Funds) (Prospectuses) (Jersey) Order 1995 will be revoked. The consultation exercise was concluded in August 2009 and the Commission has been engaged in extensive discussions with Industry on numerous technical aspects. We shall be publishing a Position Paper in the near future, including a revised version of the Order.

As mentioned above, progress also continues with the finalisation of the Funds Codes. The Commission is close to finalizing its response to the comments received from Industry and will be issuing a Feedback Statement shortly. In the interim, meetings have been held with a joint working party from Jersey Finance and the Jersey Funds Association on detailed revisions to the



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Codes. Following publication of the Feedback Statement, there will be further consultation on the date of introduction of the Codes, although precise timing may well be dictated by the implementation of the AIFMD, and the revised Principles of Securities Regulation by IOSCO referred to above.

Once the IOSCO methodology is agreed, the Division is planning to undertake a self-assessment against the revised rules in Q4 of 2011 or Q1 of 2012.

Other areas where the Securities Division will have significant input include the funds specific section of the AML Handbook, the draft Fund Services Business Client Assets Order and the Non-domiciled Fund Guide. In the light of Industry's comments on the Funds Codes, the Commission will be producing a closed-ended collective investment fund guide to complement the Open-ended Collective Investment Fund Guide.

The Commission will shortly be issuing a Consultation Paper concerning revisions to all supervision Codes of Practice, including those for fund services businesses, in order to ensure greater consistency across each supervision division.

Issues Arising

During 2010 the Division became aware of the following issues relating to funds and fund services businesses.

Fund Structures Generally

Fund structures are not necessarily simple structures. It is essential for the relevant fund services business (for example, the administrator, manager or custodian) to have knowledge and understanding of the entire structure of the Fund from top to bottom. For example, where an underlying company is not wholly-owned by the Fund, the fund services business should hold appropriate information on the other shareholders. Due diligence should also be undertaken on counterparties to the Fund's transactions.

In our experience where the Fund is complex there may be multiple underlying entities or special purpose vehicles ("SPVs") incorporated in many jurisdictions within the fund structure. This results in a multitude of directors at each layer of the structure with numerous service providers operating under different laws and regulations. For Fund directors at the top of the tree this inevitably presents an issue on how to exercise control over the whole structure. It can



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be more problematic where the underlying companies are not wholly-owned, directly or indirectly, by the Fund, or where the boards of such companies comprise members drawn from outside the promoter's group or that of the fund services business.

In particular, careful consideration should be given to ensure the directors appointed to SPVs are suitably qualified, understand the legal requirements of the relevant jurisdictions in which the SPVs are established, and that any potential conflicts have been addressed, for example where directors employed by the administrator are appointed to the Fund and/or the SPVs owned by the Fund.

In complex structures there may be third party directors on the boards of entities underlying the Fund structure with the result that the Fund directors will be placing reliance on others. The Fund directors should be satisfied it is appropriate to do so and that the reporting mechanisms ensure a clear flow of information upwards from within the structure so they are kept fully informed at all times. The Fund board should carefully review information presented to it and challenge such information when it does not appear reasonable given the nature of the Fund and its investments.

Administrator

The administrator may have both contractual responsibilities to the manager as well as responsibilities to the Fund. If the administrator provides directors to the Fund, they may be placed in a difficult position should the Fund fall into dispute with the administrator.

The administrator will almost certainly need to rely on third parties for some fund services, for example where the Fund owns SPVs in other jurisdictions. The administrator should ensure such third parties are reliable and capable of providing the information that the Fund administrator requires on a timely and consistent basis. This may prove more difficult where the administrator is not itself involved in the appointment of the third parties.

A fundamental issue for administrators is likely to be the calculation of the net asset value of the Fund. The administrator needs to ensure the methodology employed is thoroughly understood and appropriate, and that all underlying assets and liabilities are captured.



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Custodian

In respect of the custodian, commonly a Fund may be structured where the custodian holds (either itself or through its agents and delegates) all the assets of the Fund and all documents of title to such assets. If the offering document states that the custodian will hold all the assets in the Fund, the custodian should ensure it does indeed hold such assets all the way through the structure, including bank accounts and assets held at SPV level.

Protected Cell Companies

With regard to those protected cell companies that are regulated funds, the directors of the protected cell company and the directors of the individual cells must be clear about their respective duties. For example, the directors of a cell should consider whether or not it is their duty or those of the protected cell company to complete due diligence on investors in the Fund or on those with whom the Fund transacts business.

In the case of protected cell companies there is a potential further issue given that the protected cell company is the party which must contract on behalf of the cell. As there is no requirement for the boards of the cell company and the individual cells to be the same, there is further scope for conflicts of interest to arise and greater risk of insufficient control and oversight.

Executives in the role of Principal Person

We take this opportunity to remind licence holders of the Commission's expectations concerning governance. As you will be aware, Core Principle 3 of the FSB Codes of Practice requires that:

A registered person must organise and control its affairs effectively for the proper performance of its business activities and be able to demonstrate the existence of adequate risk management systems.

The Financial Services (Jersey) Law 1998 imposes a requirement for principal persons to obtain the prior consent of the Commission before acting as such, including directors or persons fulfilling an equivalent role. We note an increasing trend in the larger organisations or more complex groups for executive functions of the regulated business to be overseen by executive committees which include persons who are not directors of the registered person. This may



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result in individuals acting in an executive role but who have not been approved by us to be principal persons.

In order to avoid such situations arising, it is preferable for executive committees to comprise only members of the board of directors of the registered person, related registered persons, or key persons. In the event executive committees are to include individuals who are not existing principal persons, we recommend the individual concerned or the registered person seek guidance from the Commission.

2011 Major Objectives

In summary the main objectives for funds in 2011 are to:

- Advance the on-site visit programme
- Assist further in the development of the IOSCO Principles on Securities
- Finalize and implement the Codes for Funds
- Introduce the new Certified Funds Prospectuses Order
- Continue to monitor progress of the AIFMD and respond accordingly
- Undertake an assisted self-assessment against the revised IOSCO methodology

In addition we shall continue our close liaison with Industry and with our work in ensuring the fund authorisation process is as streamlined and efficient as possible.

Overall the Division expects to be heavily involved in matters of policy, including the IOSCO Principles, and in assessing the detailed Level II provisions of the AIFMD.



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We shall continue to engage fully with our international counterparts and to liaise closely with Industry on all matters relating to fund development and supervision.

Yours faithfully,

A handwritten signature in black ink, appearing to read "D Banks".

~~David Banks~~
Director, Securities