POLICY STATEMENT ON THE
AIMA OFFSHORE ALTERNATIVE FUND DIRECTORS’ GUIDE

June 2008
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SECTION I

I EXECUTIVE SUMMARY

The Financial Supervision Commission (“the Commission”) believes that appropriate governance of a fund is a vital element in ensuring the correct operation of that vehicle on behalf of investors. As such the composition of the governing body of a fund and its manner of operation is integral to the fund structure.

However, the selection and appointment of directors to the governing body of any fund, including a hedge fund, can pose fundamental practical, legal and tax considerations. These considerations will vary dependent on the domicile of the scheme, its investment profile and structure and complexity.

The Commission is aware of, and endorses the sound practical guidance in AIMA’s Offshore Alternative Fund Directors’ Guide – 2nd edition 2008 and would draw this report to the attention of governing bodies and functionaries of alternative investment funds operated in or from the Island. The revised guide appears at a time of increased scrutiny and debate surrounding the role of directors of offshore funds, particularly hedge funds, and it provides advice on the selection and appointment of directors of offshore funds aimed both at fund sponsors and individuals that are considering serving as directors.

The Commission views this document as setting out appropriate best practice standards and practical guidance which should be considered in relation to the selection and appointment of directors.

To obtain a copy of the AIMA report please contact AIMA at info@aima.org.

John R Aspden
9 June 2008
SECTION 2

2 Background - The Isle of Man Hedge Fund Industry

Although there is no universally accepted legal definition of a “hedge fund” or Alternative Fund, it is generally agreed that a hedge fund is an investment structure that has some or all of the following characteristics:

- High levels of leverage;
- Significant performance fees paid to the asset manager in addition to the annual management fee;
- An ability for investors to redeem their interests periodically;
- Significant “own” funds invested by the asset manager;
- Speculative use of derivatives and the ability to short sell; and/or
- The involvement of more diverse risks or complex underlying products. (See IOSCO’s Report on “The Regulatory Environment for Hedge Funds”, published in November 2006).

The following characteristics might also be accepted by many as common:

- Alternative and often highly complex investment strategies, including short selling, investment in illiquid assets or assets with uncertain or long-term liquidity, derivative assets which are not quoted on recognised exchanges, derivative synthetic assets which are unquoted and thus hard to value, high concentration or activist investing, multiple intra-day trading, or a combination of these strategies
- Aimed at “institutional” or very high net worth investors;
- Subject to light touch regulation or unregulated, often in the context of a regime where the regulation is aimed at the functionaries rather than the fund itself.

Based on these characteristics, some of the more lightly regulated funds directed at specialist investors as well as unregulated (exempt and closed-ended) funds could be characterised as “hedge funds”. It follows that recent developments in relation to the global hedge fund industry are relevant to some Isle of Man funds, albeit that, in common with other jurisdictions, the Island’s legislation as yet contains no definition of that term.

The recent rapid growth of the alternative fund industry in the Isle of Man has been accompanied by a change in the nature of the funds themselves, with a move towards the use of closed-ended listed funds and increasing diversity in the range of “alternative” investment strategies employed. In view of the clear marketing opportunities and the vision and enthusiasm of the industry, the fund sector is likely to continue to play a major role in the development of the financial services industry in the Island in the short to medium term.
The Regulation of Hedge Funds

Investment in a hedge fund intrinsically attaches a number of complex and additional significant risks which are not common in an investment in, for example, a highly regulated Authorised Scheme aimed at the retail market. As regulator, the Commission must seek to mitigate these intrinsic risks in the interests of investors and the reputation of the Island. In doing so, it has sought to develop an appropriate regulatory regime which promotes a balanced approach to regulation, addressing the regulatory risks inherent in the operation and management of hedge funds while allowing the industry the freedom it needs to flourish.

In developing its regulatory approach, the Commission is mindful of the approach taken in other jurisdictions and by the international standard-setters who judge the adequacy of the Island’s regime. This is highly relevant to the regulation of the hedge fund industry as its rapid expansion has given rise to increasing and global regulatory and economic interest. Although there is no consistent approach to the regulation of hedge funds, the risks of poor or inappropriate regulation are high. A number of studies have sought to analyse the risks, including the IOSCO report cited above.

There is also increasing evidence of international regulatory initiatives in relation to the establishment of “standards” for hedge fund governing bodies (meaning the directors, trustee or partners, as appropriate of the fund company, unit trust, or partnership) and managers. These initiatives include not only the establishment of formal regulatory standards in individual jurisdictions but also a suggestion from the European Central Bank that there should be a “code of conduct” for hedge funds.

The Commission welcomes these international initiatives and equally welcomes the fact that the hedge fund industry itself is seeking to establish “self-regulation” in the form of best practice guidance developed by the industry for the industry.
The London-based Alternative Investment Management Association has launched an updated version of its Offshore Alternative Fund Directors’ Guide, first published in June 2005, as part of AIMA’s far-reaching body of work in the arena of sound practices and corporate governance.

The guide includes recommendations on key areas, including the independence of non-executive directors and conflicts of interest, as well as auditors’ communications and representations to the board.

It explains the fundamental legal and tax implications that need be taken into consideration when directors are appointed to a fund, and sets out the basic tasks fund directors should carry out, as well as guidelines on issues such as liability insurance and taxation.

It provides advice on the selection and formal appointment of directors of offshore funds for both fund managers and individuals considering serving as directors themselves.

Areas covered in the Guide include useful guidance and recommendations in relation to:

- Tax issues
- Independent directors, local directors and officers
- How to select and appoint directors and terms of appointment
- Considerations for the board as a whole including
  - Composition and competence
  - Remuneration
  - Liability
  - Operation of board meetings
  - Relationship with the investment manager and auditors
  - The role of the board
  - Directors’ and Officers’ Liability Insurance

The guide will be a valuable resource for members of the governing bodies of hedge funds as well as for hedge fund promoters and functionaries. It is expected that the guide will also be valuable to investors who wish to understand the roles and responsibilities of fund directors.