



**BERMUDA**

**INVESTMENT BUSINESS (ALTERNATIVE INVESTMENT  
FUND MANAGERS) RULES 2016**

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SCHEDULE I  
Quantitative Reporting Requirements of AIFMs

SCHEDULE II  
Obligations of Depositaries

SCHEDULE III  
Calculation of Leverage

The Bermuda Monetary Authority, in exercise of the power conferred by section 19H of the Investment Business Act 2003, makes the following Rules:

**Citation**

1 These Rules may be cited as the Investment Business (Alternative Investment Fund Managers) Rules 2016.

**Interpretation**

2 (1) In these Rules—

“the Act” means the Investment Business Act 2003;

“authorised” means the permission granted to an entity to carry on an activity under the oversight of a competent authority responsible for the regulation and supervision of the activities to be carried on by the entity, and includes “licensed”, “registered” or any other similar term;

“Authority” means the Bermuda Monetary Authority established by the Bermuda Monetary Authority Act 1969;

“carried interest” means a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF, and excludes any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM in the AIF;

“close links” means a situation in which two or more persons are—

(a) linked by participating interest in a company as defined by section 6 of the Act;

(b) linked by control, namely the relationship between a parent undertaking and a subsidiary, as defined by section 5 of the Act;

(c) linked to the same person by a control relationship;

“competent authority” means the regulatory authority of an overseas jurisdiction that is empowered by law to supervise AIFMs, AIFs or depositaries;

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“constitution” means the formation documents of an AIF including, but not limited to, the memorandum and articles of association, bye-laws, trust deed, or partnership agreements;

“depository” means a person appointed in accordance with paragraph 26;

“employees’ representatives” means the employees’ representatives of an undertaking as provided under the Trade Union Act 1965, or under the laws and practices of an overseas jurisdiction where the undertaking has its registered office;

“established” means, for AIFs which are not authorised, the jurisdiction where the AIF has its head office;

“EU” means the European Union of 28 member states;

“external valuer” means a person who performs the valuation function, described in these Rules, in respect of an AIF managed by an AIFM and who is not the AIFM of that AIF;

“feeder AIF” means an AIF which—

- (a) invests at least 85% of its assets in units or shares of another AIF (a master AIF);
- (b) invests at least 85% of its assets in more than one master AIF where those master AIFs have identical investment strategies; or
- (c) otherwise has an exposure of at least 85% of its assets to such a master AIF;

“financial instrument” means an investment as prescribed by Part 1 of the First Schedule to the Act, or such similar instrument as prescribed by the law of the jurisdiction where the AIF is authorised or established;

“governing body” means, in relation to—

- (a) a company, the board of directors;
- (b) a partnership, the general partner;
- (c) a trust, the trustee; or
- (d) any other entity, such persons performing functions corresponding to those persons respectively referred to in paragraphs (a), (b) and (c) by whatever name called;

“IFA” means the Investment Funds Act 2006;

“issuer” means an undertaking governed by private or public law, including a state, whose securities are admitted to trading on a regulated market;

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“leverage” means any method by which the AIFM increases the exposure of an AIF it manages, whether through borrowing of cash or securities, or leverage embedded in derivative positions, or by any other means;

“master AIF” means an AIF in which another AIF (a feeder AIF) invests or has an exposure in accordance with the definition of feeder AIF;

“material change” for the purposes of paragraphs 36 and 37, means a change which, if known, would reasonably affect the mind of a prudent participant in deciding whether to participate or to continue to participate in the AIF;

“minimum capital” means the regulatory capital requirement as prescribed under paragraph 5, which AIFMs will have to fulfil as part of their initial licensing process to meet the minimum licensing criteria under the Act;

“non-listed company” means an undertaking, the shares of which are not admitted to trading on a regulated market;

“prime broker” has the meaning given in section 2 of the IFA;

“prospectus” has the meaning given to “fund prospectus” under section 2 of the IFA, and where the AIF is not subject to the IFA, the document required under the law of the jurisdiction where the AIF is authorised or established by whatever name;

“regulated market” means an investment exchange or clearing house recognised by the Authority under section 71 of the Act, or such other investment exchange or clearing house regulated by an overseas regulator recognised by the Authority;

“share” has the meaning given in section 2 of the Companies Act 1981;

“special arrangement” means an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impacts the specific redemption rights of investors in a type of unit or share of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors;

“units” has the meaning given in section 2 of the IFA.

(2) For the purposes of these Rules, “control” in relation to acquisition and reporting requirements means—

- (a) for a non-listed company, holding more than 50% of the voting rights of the non-listed company; and
- (b) for an issuer, the percentage of voting rights and the method of its calculation, determined in accordance with the law where the issuer is listed pertaining to the takeover of a corporate body.

(3) When calculating the percentage of voting rights for the purposes of subparagraph (2), if subparagraph (2)(b) does not apply, in addition to the voting rights held directly by the AIF, the voting rights of the following shall be taken into account, subject to control being established—

- (a) an undertaking controlled by the AIF; and
- (b) a person acting in their own name but on behalf of the AIF, or on behalf of an undertaking controlled by the AIF,

and the percentage of voting rights shall be calculated on the basis of issued shares to which voting rights are attached, even if the exercise of those rights is suspended.

*Application for licence*

**Application for licence by an AIFM: information to be provided**

3 In relation to an application under section 16 of the Act to which section 19E of the Act applies, an applicant must provide the following information with the application—

- (a) identities of the AIFM's shareholders or members, whether direct or indirect, that are shareholder controllers and the amounts of those shareholdings, accompanied by an explanation as to how this is suitable taking into account the need to ensure the sound and prudent management of the AIFM;
- (b) confirmation as to whether the applicant is an external or internal AIFM;
- (c) a description of the programme of activity of the AIFM together with an explanation of how the AIFM intends to comply with its obligations under the Act and these Rules;
- (d) a description of the investment activities to be carried on, including discretionary portfolio management for persons other than an AIF for which it is an external AIFM;
- (e) copies of the applicant's remuneration policies and practices;
- (f) the address of the head office and the registered office of the AIFM;
- (g) where the AIFM intends to market funds in an overseas jurisdiction, the name and address of any representative in that jurisdiction as applicable;
- (h) in relation to each AIF that it manages—
  - (i) fund specific information as directed by the Authority;
  - (ii) a description of the investment strategies and, in relation to a fund of funds, information on the types of underlying funds;

- (iii) the policy regarding use of leverage, risk profiles and other characteristics of the AIFs it manages or intends to manage;
- (iv) identification of the jurisdiction where the AIF is authorised or established, or expected to be authorised or established;
- (v) in the case of a feeder AIF, identification of the jurisdiction where the master AIF is authorised;
- (vi) a copy of the constitution and prospectus of each AIF that it proposes to manage and, if applicable, any additional information disclosed to investors;
- (vii) appointment of a depositary for each AIF it manages and the identification of the depositary;
- (i) confirmation that the AIFM has fulfilled, and how it is able to maintain, the minimum capital and liquidity requirements;
- (j) confirmation regarding the arrangements made for the independent valuation of assets and the calculation of the net asset value per unit or share of the AIF, in accordance with paragraph 17, including identification of the person performing the independent valuation function;
- (k) details of the applicant's arrangements on delegation and sub-delegation in accordance with these Rules, including identification of any delegates or sub-delegates;
- (l) details regarding the leverage and risk limits adopted by the AIFM in relation to each AIF it manages, in accordance with paragraphs 14 and 40.

#### **Prerequisite for licensing**

4 The Authority must be satisfied that the AIFM has the capacity to perform at least the services of risk management and portfolio management.

#### *Capital and liquidity requirements*

#### **Minimum capital**

5 (1) An internal AIFM must have a minimum amount of capital that is the equivalent of EUR 300,000.

(2) An external AIFM must have a minimum amount of capital that is the equivalent of EUR 125,000.

### **Total capital**

6 (1) Where the total value of the portfolios of AIFs managed by the AIFM exceeds the equivalent of EUR 250 million, the AIFM must provide an additional amount of capital that is equal to 0.02% of the amount in excess of the equivalent of EUR 250 million.

(2) The total amount of capital is not required to exceed the equivalent of EUR 10 million.

(3) For the purpose of calculating the total value mentioned in subparagraph (1)—

(a) the total value of the portfolios of the following AIFs must be included—

(i) AIFs managed by the AIFM;

(ii) AIFs for which the AIFM has delegated functions;

(b) the total value of portfolios of AIFs that the AIFM is managing under delegation shall not be included.

(4) The Authority may, on the application of an AIFM, exempt the AIFM from complying with the requirements of subparagraph (1) and direct that the AIFM may be permitted to not provide up to 50% of the additional capital if there is in force in relation to the AIFM a guarantee of the same amount given by a bank, or an insurance undertaking which is subject to supervision by the Authority, or is authorised by a competent authority of a member state of the EU.

(5) Without prejudice to the provisions outlined in subparagraphs (1) to (4), the Authority may increase the total capital amount where the Authority is of the view that the total amount of capital does not reasonably reflect the current position of the AIFM.

### **Liquidity**

7 (1) An AIFM shall maintain a minimum level of liquidity at all times equivalent to three months of an AIFM's annual expenditure.

(2) Annual expenditure shall be based on the latest annual financial statements of an AIFM and comprises total revenue less profit before appropriations.

(3) Assets may be held to meet all or a portion of the minimum liquidity requirement provided that the assets are maintained in a form that is able to be converted to cash within a reasonable period of time by the AIFM.

### **Breach of minimum capital and liquidity requirements**

8 (1) An AIFM shall notify the Authority in writing within 14 days if it anticipates being in breach of the minimum capital and liquidity requirements set out in paragraphs 5 to 7.

(2) The notification shall contain the steps that the AIFM is taking or has taken to remedy the breach.



(3) Within 28 days of the date of the notification, the Authority may direct the AIFM to submit information regarding minimum capital and liquidity to demonstrate compliance with the requirements of these Rules.

#### **Professional liability risks**

9 To address professional liability risks resulting from regulated activities carried out by an AIFM, an AIFM shall either—

- (a) hold additional capital which is appropriate to cover potential liability risks arising from professional negligence; or
- (b) obtain professional indemnity insurance to cover liability risks arising from professional negligence.

#### *Organisational requirements*

#### **General organisational requirements**

10 (1) An AIFM shall at all times use adequate and appropriate human and technical resources necessary for the proper management of the AIFs which it manages.

(2) The AIFM must in particular adopt—

- (a) sound administrative and accounting procedures;
- (b) control and safeguard arrangements for electronic data processing;
- (c) adequate internal control mechanisms including, in particular—
  - (i) policies and procedures for personal transactions by its employees;
  - (ii) policies and procedures for the holding or management of investments in order to invest on its own account;
  - (iii) ensuring, at least, that each transaction involving the AIFs may be reconstructed according to its origin, the parties to it, its nature, and the time and place it was effected;
  - (iv) ensuring that the assets of the AIFs managed by the AIFM are invested in accordance with the law of the jurisdiction where the AIF is authorised, registered, or established and the constitution and prospectus of the AIF.

#### *Operating conditions*

#### **General operating conditions**

11 (1) An AIFM shall at all times comply with the following principles—

- (a) act honestly and fairly with due skill, care and diligence when conducting its activities;
- (b) act in the best interests of the AIFs, or the investors of the AIFs it manages;
- (c) have and employ the resources and procedures that are necessary for the performance of its business activities;
- (d) take all reasonable steps to avoid conflicts of interest and where this cannot be avoided, ensure that those conflicts of interest are disclosed in order to prevent them from adversely affecting the interests of the AIFs and their investors;
- (e) comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of the AIFs, or the investors of the AIFs, and the integrity of the market;
- (f) ensure that the AIFs and their investors are treated fairly;
- (g) except where disclosed in the AIF's constitution and prospectus, ensure that no investor in an AIF should receive preferential treatment.

(2) Where an AIFM undertakes to carry on portfolio management on a discretionary basis which was not approved as one of the conditions of licensing by the Authority, it must notify the Authority as a material change under section 19G of the Act.

(3) An AIFM whose licence permits it to perform portfolio management services on a discretionary basis must not invest all or part of the client's portfolio in units of any AIF that it manages—

- (a) without having first obtained the client's approval to do so; and
- (b) without giving the Authority notice, of at least 14 days, of its intention to do so.

### **Remuneration**

12 (1) Every AIFM shall establish and maintain remuneration policies and practices for persons whose professional activities have a material impact on the risk profile of the AIFM.

- (2) Remuneration policies are required to—
- (a) be consistent with the risk management policy of the AIFM;
  - (b) promote sound and effective risk management;
  - (c) not encourage risk-taking which is inconsistent with the risk profiles or constitutions of the AIFs it manages.

(3) In this paragraph, "persons whose professional activities have a material impact on the risk profile of the AIFM" include, but are not limited to, chief executive officers, senior executives or any employee carrying out a risk related activity and whose remuneration puts them in the same bracket as senior executives.

**Conflicts of interest**

13 (1) An AIFM shall establish and maintain policies and procedures relating to identifying, preventing, managing and monitoring conflicts of interest in accordance with subparagraph (2).

(2) An AIFM shall, in the course of managing AIFs, identify—

(a) conflicts of interest that may arise between—

- (i) itself and its controllers, directors, senior executives or associates; and
- (ii) the AIF or any of its investors;

(b) conflicts of interest that may arise between—

- (i) the AIF or its investors; and
- (ii) another AIF or its investors;

(c) conflicts of interest that may arise between—

- (i) the AIF or its investors; and
- (ii) another client of the AIFM; or

(d) conflicts of interest that may arise between two clients of the AIFM.

(3) An AIFM shall segregate, within its own operating environment, tasks and responsibilities which may be regarded as incompatible with each other or which may potentially generate systematic conflicts of interest.

(4) An AIFM shall regularly assess whether its operating conditions may involve any other material conflicts of interest and disclose them to the investors of the AIFs.

(5) Where an AIFM no longer has confidence that it is operating in accordance with its conflicts of interest policies and procedures, the AIFM must disclose the general nature or sources of conflicts of interest to the Authority, the AIF and its investors, before undertaking business on behalf of the AIF.

(6) Where the AIFM on behalf of an AIF engages the services of a prime broker, the terms must be set out in writing.

(7) Where an engagement for services under subparagraph (6) has been entered into, the AIFM must inform the depositary of an AIF of such engagement.

(8) An AIFM must exercise due skill, care and diligence in the selection of prime brokers.

(9) Any provisions on transfer and re-use of AIF assets must be set out in the terms of such engagement and must be consistent with the AIF's constitution and prospectus.

### **Risk management**

14 (1) An AIFM must functionally and hierarchically separate the functions of risk management from its operating units, including from the functions of portfolio management.

(2) An AIFM must ensure that specific safeguards against conflicts of interest allow for the independent performance of risk management activities and that the risk management process satisfies the requirements of this paragraph.

(3) An AIFM must implement adequate risk management systems, policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed.

(4) An AIFM must review its risk management systems at least once a year and adapt them when necessary.

(5) An AIFM must set a maximum level of leverage which it may employ on behalf each AIF it manages and the extent of the right to re-use collateral or guarantee that could be granted under the leveraging arrangement, taking into account—

- (a) the investment strategy of the AIF;
- (b) the sources of leverage of the AIF;
- (c) any other interlinkage or relationships with other financial services institutions, which could pose systemic risk;
- (d) the need to limit the exposure to any single counterparty;
- (e) the extent to which the leverage is collateralised;
- (f) the asset-liability ratio; and
- (g) the scale, nature and extent of the activity of the AIFM on the markets concerned.

(6) Where an AIFM determines that it is no longer operating within the maximum leverage limits disclosed to the Authority at the time of licensing, it shall notify the Authority as a material change under section 19G of the Act.

(7) An AIFM must establish and maintain qualitative or quantitative risk limits, or both, for each AIF it manages, taking into account all relevant risks.

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(8) The qualitative and quantitative risk limits for each AIF must, at least, cover the following risks—

- (a) market risks;
- (b) credit risks;
- (c) liquidity risks;
- (d) counterparty risks;
- (e) operational risks.

(9) Where an AIFM determines that it is no longer operating within its risk limits disclosed to the Authority at the time of licensing or subsequently, it shall notify the Authority as a material change under section 19G of the Act.

(10) An AIFM must—

- (a) when investing on behalf of an AIF, establish and maintain a documented and regularly updated due diligence process, according to the investment strategy, the objectives and risk profile of the AIF;
- (b) ensure that the risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be identified, measured, managed and monitored on an ongoing basis, including through the use of appropriate stress testing procedures;
- (c) ensure that the risk profile of the AIF corresponds to the size, portfolio structure, investment strategies, and objectives of the AIF as required under its constitution and prospectus;
- (d) ensure that the risk profile of the AIF is disclosed to investors and is consistent with the risk limits set out in this paragraph;
- (e) monitor compliance by the AIF with the risk limits set out in this paragraph.

(11) An AIFM shall implement procedures relating to notification to the governing body of the AIFM when the AIF's risk profile is, or shall be, inconsistent with required risk limits.

(12) An AIFM's procedures must make provision for periodic updates to be provided to the AIFM's governing body regarding the following matters—

- (a) the consistency between, and compliance with, the risk limits and the risk profile as disclosed to investors of the AIFs; and
- (b) the adequacy and effectiveness of the risk management process, indicating in particular, whether appropriate remedial measures have been or will be taken in the event of any actual or anticipated deficiencies.

(13) The procedures required in accordance with subparagraph (12) shall also make provision for regular updates to be given to senior executives which outline the current level of risk incurred by each managed AIF and any actual or foreseeable breaches of risk limits.

(14) When setting risk limits, an AIFM shall take into account the strategies and assets employed in respect of each AIF it manages as well as the law of the jurisdiction where the AIF is authorised or established; and the risk limits must also be aligned with the risk profile of the AIF, approved by the AIF's governing body and disclosed to its investors.

### **Liquidity management**

15 (1) An AIFM shall, for each AIF that it manages which is not an unleveraged closed-ended AIF, employ an appropriate liquidity management system and adopt procedures which enable it to monitor the liquidity risk of the AIF and ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations.

(2) An AIFM shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable it to assess and monitor the liquidity risk of the AIFs it manages.

(3) An AIFM shall ensure that for each AIF it manages the investment strategy, the liquidity profile, and the redemption policy are consistent with one another.

### **Investment in securitisation positions**

16 (1) In this paragraph—

(a) "credit institution" means—

(i) a bank licensed under the Banks and Deposit Companies Act 1999;

(ii) an entity authorised by a member state of the EU to carry out banking functions;

(b) "securitisation" means a transaction or scheme whereby the credit risk associated with an exposure or pool of exposures is tranching, having the following characteristics—

(i) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and

(ii) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;

(c) "securitisation position" means an exposure to a securitisation;

(d) "sponsor" means a credit institution other than an originator credit institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities;

(e) "tranche" means a contractually authorised segment of the credit risk associated with an exposure or number of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in each other such segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments.

(2) An AIFM must assume exposure to the credit risk of a securitisation on behalf of one or more AIFs it manages only if the originator, sponsor or original lender has explicitly disclosed to the AIFM that it retains, on an ongoing basis, a material net economic interest, which must not be less than 5%.

(3) Only the following shall qualify as retention of a material net economic interest of not less than 5%—

- (a) retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors of the AIF;
- (b) in the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5% of the nominal value of the securitised exposures;
- (c) retention of randomly selected exposures, equivalent to not less than 5% of the nominal value of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is not less than 100 at origination;
- (d) retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors of the AIF and not maturing any earlier than those transferred or sold to investors of the AIF, so that the retention equals in total not less than 5% of the nominal value of the securitised exposures;
- (e) retention of a first loss exposure of not less than 5% of every securitised exposure in the securitisation.

(4) Net economic interest must be measured at the origination and must be maintained on an ongoing basis.

(5) The net economic interest, including retained positions, interest or exposures, must not be subject to any credit risk mitigation or any short positions or any other hedge and shall not be sold.

(6) The net economic interest must be determined by the notional value for off-balance sheet items.

(7) There must be no multiple applications of the retention requirements for any given securitisation.

*Independent valuation*

**Valuation**

17 (1) An AIFM must, for each AIF that it manages, ensure that policies and procedures appropriate to the nature, scale and complexity of the business are adopted and implemented so that a proper and independent valuation of the assets of the AIF can be performed in accordance with these Rules, the constitution and prospectus of the AIF, and the law of the jurisdiction where the AIF is authorised or established.

(2) An AIFM shall ensure that the valuation shall be performed impartially and with all due skill, care and diligence.

(3) An AIFM must ensure that the net asset value per unit or share of an AIF is calculated and disclosed to the investors of such AIF in accordance with these Rules, the constitution and prospectus of the AIF, and the law of the jurisdiction where the AIF is authorised or established.

(4) The AIFM must ensure that the assets are valued and the net asset value per unit is calculated at least once every year.

(5) If the AIF is open ended, the AIFM must ensure that such valuations and calculations are carried out at a frequency which is appropriate to the assets held by the AIF and its issuance and redemption frequency.

(6) If an AIF is closed-ended, an AIFM must carry out such valuations and calculations in the event of an increase or decrease of the capital by the relevant AIF.

(7) An AIFM must inform investors of the AIF of the valuation and calculation as set out in these Rules, the constitution and prospectus of the AIF, and the law of the jurisdiction where the AIF is authorised or established.

**Appointment of valuers**

18 (1) An AIFM must ensure that the valuation function is performed by—

- (a) an external valuer, who must be a person independent of the AIF, the AIFM and any other persons with close links to the AIF or the AIFM; or
- (b) the AIFM itself, provided that the valuation task is functionally independent from the portfolio management, and the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon the employees is prevented.

(2) An AIFM must ensure that the depositary of an AIF is not appointed as the external valuer of that AIF unless it is satisfied that the depositary has functionally and



hierarchically separated the performance of its depositary function from its tasks as an external valuer, and that it is able to manage the potential conflicts of interest, and monitor and disclose them to the investors of the AIF.

(3) Where a valuation is to be performed by an external valuer and this arrangement was not approved by the Authority at the time of licensing, the AIFM shall notify the Authority as a material change under section 19G of the Act.

(4) Where the valuation function is not performed by an external valuer, the Authority may require the AIFM to have its valuation procedures or valuations, or both, verified by an external valuer or, where appropriate, an auditor.

#### **Qualifications of a valuer**

19 Where an external valuer performs the valuation function, the AIFM must ensure and demonstrate that—

- (a) the external valuer is subject to mandatory registration under the law or to rules of professional conduct;
- (b) the external valuer can provide sufficient professional guarantees to be able to effectively perform the relevant valuation function in accordance with these Rules;
- (c) the appointment of the external valuer complies with the requirements of paragraphs 22 to 25 on delegation.

#### **Duties of a valuer**

20 (1) An external valuer must perform the valuation function set out in these Rules impartially and with all due skill, care and diligence.

(2) An external valuer must not delegate the valuation function to a third party.

#### **Valuation: liability of AIFM**

21 (1) An AIFM is responsible for the proper valuation of AIF assets, the calculation of the net asset value of the AIF, and publication of that net asset value.

(2) Any such liability towards the AIF and its investors shall not be affected by the appointment by the AIFM of an external valuer in respect of that AIF.

(3) Irrespective of any contractual arrangement that provides otherwise, an external valuer is liable to the AIFM of an AIF in respect of which the valuer is appointed for any losses suffered by the AIFM as a result of the external valuer's negligence or intentional failure to perform its tasks.

*Delegation of AIFM's functions*

**Delegation: general provisions**

- 22 (1) An AIFM may delegate its functions to third parties if—
- (a) the AIFM is able to justify its entire delegation structure on objective reasons;
  - (b) the delegate has sufficient resources to perform the delegated functions;
  - (c) the persons who effectively conduct the business of the delegate are fit and proper, are of good repute and are sufficiently experienced to perform the functions delegated to them;
  - (d) the delegation must not prevent the effectiveness of supervision of the AIFM and, in particular, must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors.
- (2) The AIFM must be able to demonstrate to the Authority that—
- (a) the delegate is qualified and capable of undertaking the functions in question;
  - (b) the delegate was selected for appointment with all due care;
  - (c) the AIFM is in a position to effectively monitor the delegated activity;
  - (d) the AIFM is able at any time to give the delegate further instructions;
  - (e) the AIFM is able at any time to revoke the delegation with immediate effect when this is in the best interests of investors.
- (3) The AIFM must review the services provided by each delegate on an ongoing basis.
- (4) An AIFM must not delegate, and a delegate must not sub-delegate, portfolio management or risk management functions to—
- (a) a depositary or sub-delegate;
  - (b) any other undertaking whose interests may conflict with those of the AIFM or the investors of the AIF,

unless such undertaking has functionally and hierarchically separated its portfolio management or risk management functions from its other potentially conflicting functions, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.

- (5) An AIFM must not delegate its functions to the extent that it becomes a post office box entity and can no longer be considered to be the manager of the AIF.

(6) For the purposes of subparagraph (1), delegation shall be deemed to prevent the effective supervision of the AIFM where—

- (a) the AIFM, its auditors and the Authority do not have effective access to data related to the delegated functions and to the business premises of the delegate, or the Authority is not able to exercise those rights of access;
- (b) the delegate does not cooperate with the Authority of the AIFM in connection with the delegated functions;
- (c) the AIFM does not make available on request to the Authority all information necessary to enable the Authority to supervise the compliance of the performance of the delegated functions with the requirements of the Rules.

#### **Appointment of a delegate**

23 (1) An AIFM shall not delegate its portfolio management or risk management functions without the approval of the Authority.

(2) Notwithstanding subparagraph (1), the Authority may allow an AIFM to delegate either its portfolio management or risk management functions upon approval, but not both.

(3) Where an AIFM delegates the task of carrying out its portfolio management or risk management functions and such delegation was not approved by the Authority at the time of licensing or thereafter, the AIFM is required to notify the Authority as a material change under section 19G of the Act.

#### **Sub-delegation**

24 (1) A delegate may sub-delegate any of the functions delegated to it provided the conditions in subparagraph (2) are met.

(2) Those conditions referred to in subparagraph (1) are—

- (a) the delegate has received consent from the AIFM prior to the sub-delegation;
- (b) the AIFM has notified the Authority in writing before the arrangements have become effective;
- (c) in relation to the conditions set out in paragraph 22, on the understanding that all references to the 'delegate' include references to a further 'sub-delegate'.

(3) A delegate or sub-delegate which has delegated such functions must review on an ongoing basis the services and functions provided by the delegate or sub-delegate.

**Liability following delegation**

25 Irrespective of any contractual arrangements that provide otherwise, any liability of an AIFM towards the AIF it manages or towards investors of such an AIF is not affected by—

- (a) the delegation by the AIFM of any of the AIFM functions;
- (b) any sub-delegation of such functions by the delegate to another person;  
or
- (c) any further sub-delegation of such functions by a sub-delegate.

*Depositaries*

**Depositaries: general provisions and appointment**

26 (1) An AIFM shall ensure that a single depositary is appointed for each AIF that it manages.

(2) Undertakings eligible to be appointed as a depositary are—

- (a) a bank licensed under the Banks and Deposit Companies Act 1999; or
- (b) an undertaking authorised by a competent authority of a member state of the EU to carry out the functions of a depositary.

(3) Every depositary shall be engaged by written contract which specifies the obligations required for the depositary to perform its functions for the AIF.

(4) An AIFM shall notify the Authority in writing of any change to the appointment of a depositary as a material change under section 19G of the Act.

(5) Liability to the investors of the AIF may be invoked directly or indirectly through the AIFM, depending on the legal nature of the relationship between the depositary, the AIFM and the investors.

(6) An AIFM shall provide the depositary, upon commencement of its duties and on an ongoing basis, with all relevant information it needs in order to comply with its obligations pursuant to paragraph 31, including information to be provided to the depositary by third parties.

(7) Schedule II applies in respect of the appointment of a depositary under this paragraph.

**Depositaries: conflicts of interest**

27 (1) An AIFM shall not act as the depositary of any AIF that it manages.

(2) A depositary shall act honestly, fairly, professionally, independently and in the best interest of the AIF and its investors.

(3) A depositary shall not carry out activities with regard to the AIF or the AIFM on behalf of the AIF that may create conflicts of interest between the AIF, the investors in the AIF, the AIFM and itself, unless the depositary has functionally and hierarchically separated the performance of its depositary functions from its other potentially conflicting tasks.

(4) A depositary shall ensure that potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.

(5) A depositary shall not re-use assets of the AIF, or of the AIFM acting on behalf of the AIF, that have been entrusted to it for safe-keeping without the prior consent of the AIF or the AIFM acting on its behalf.

(6) An AIFM shall not appoint a prime broker, who is acting as counterparty to an AIF, to be its depositary unless it is satisfied that the prime broker—

- (a) has functionally and hierarchically separated its depositary function from its prime broker function;
- (b) is able to properly identify, manage, and monitor conflicts of interest; and
- (c) will disclose such conflicts of interest to investors of the AIF.

**Duties of a depositary: cash flow monitoring**

28 (1) A depositary shall properly monitor an AIF's cash flows and must ensure that all payments made by or on behalf of investors of such AIF upon subscription of units or shares of an AIF have been received.

(2) A depositary shall ensure that all cash of the AIF is booked in cash accounts opened in the name of—

- (a) the AIF;
- (b) the AIFM acting on behalf of the AIF; or
- (c) the depositary acting on behalf of the AIF.

(3) Where a depositary opens a cash account in its own name, acting on behalf of the AIF, it must not book on such an account the depositary's own cash.

(4) Schedule II applies in respect of the obligations of a depositary under this paragraph.

**Safekeeping of assets: financial instruments**

29 (1) The assets of the AIF, or the AIFM acting on behalf of the AIF, that comprise financial instruments that can be held in custody, must be entrusted to the depositary for safe-keeping as provided in subparagraphs (2) and (3).

(2) The depositary must hold in custody all financial instruments that can be registered in a financial instruments account opened in the depositary's books and all financial instruments that can be physically delivered to the depositary.

(3) For that purpose, the depositary must ensure that all those financial instruments that can be registered in a financial instruments account opened in the depositary's books are registered in the depositary's books within segregated accounts opened in the name of the AIF, or the AIFM acting on behalf of the AIF, so that they can at all times be clearly identified as belonging to the AIF in accordance with the law which applies to the depositary in the jurisdiction where it is authorised.

(4) Schedule II applies in respect of the obligations of a depositary under this paragraph.

**Safekeeping of assets: other assets**

30 (1) A depositary shall verify that the other assets it holds on behalf of an AIF, or the AIFM acting on behalf of an AIF, are owned by the AIF or the AIFM acting on behalf of the AIF.

(2) A depositary shall maintain a record of all assets that it has verified.

(3) A depositary shall verify ownership on the basis of information and documents provided to it by the AIF, or the AIFM acting on behalf of the AIF, or other evidence of ownership available to it.

(4) A depositary shall keep its records up to date.

(5) Schedule II applies in respect of the obligations of a depositary under this paragraph.

**Depositaries: general compliance**

31 (1) A depositary of an AIF, or an AIFM acting on behalf of an AIF, shall ensure that—

- (a) the following requirements are fulfilled in accordance with these Rules, the constitution, the prospectus of the AIF, and the law of the jurisdiction where the AIF is authorised or established—
  - (i) the sale, issue, re-purchase, redemption and cancellation of units or shares of the AIF are carried out;
  - (ii) the values of the units or shares of the AIF are calculated;
  - (iii) the instructions of the AIFM are carried out, unless there is a conflict with these Rules, the constitution, the prospectus, or the law of the jurisdiction where the AIF is authorised or established;

- (b) in transactions involving the AIF's assets, any consideration is remitted to the AIF without delay;
- (c) an AIF's income is applied in accordance with these Rules, the constitution, the prospectus, and the law of the jurisdiction where the AIF is authorised or established.

(2) Schedule II applies in respect of the obligations of a depositary under this paragraph.

**Depositary: delegation of functions**

32 (1) A depositary shall not delegate its functions, with the exception of those relating to safe-keeping of assets.

(2) If a depositary delegates any of the activities outlined in paragraphs 29 and 30 of these Rules, the following conditions shall apply—

- (a) the depositary shall not delegate any functions to an undertaking if the purpose of the delegation is to enable it to avoid compliance with its obligations under these Rules;
- (b) there are objective reasons for the delegation;
- (c) the depositary has exercised all due skill, care and diligence in the selection and appointment of the delegate, and continues to exercise all due skill, care and diligence in the periodic review and ongoing monitoring of any delegate to whom it has delegated parts of its tasks, and of the arrangements of the delegate in respect of the matters delegated to it; and
- (d) the depositary ensures that the delegate, at all times during the performance of the delegated tasks, satisfies the conditions of subparagraph (3).

(3) The conditions referred to in subparagraph (2)(d) are—

- (a) the delegate has the structure and the expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF, or of the AIFM acting on behalf of the AIF, which have been entrusted to it;
- (b) in relation to custody tasks referred to in paragraphs 29 and 30, the delegate is subject to effective prudential regulation, including minimum capital requirements, and supervision in the jurisdiction concerned, and the delegate is subject to an external periodic audit to ensure that the financial instruments are in its possession;
- (c) the delegate segregates the assets of the depositary's clients from its own assets and from the assets of the depositary in such a way that they can,

at all times, be clearly identified as belonging to clients of a particular depositary;

- (d) the delegate does not make use of the assets without the prior consent of the AIF, or the AIFM acting on behalf of the AIF, and prior notification to the depositary; and
- (e) the delegate complies with the general obligations and prohibitions set out in paragraphs 27, 29, 30 and 31.

(4) A delegate to whom functions have been delegated under this paragraph may sub-delegate any or all of the delegated functions to a sub-delegate and, in such a case, the requirements of this paragraph apply mutatis mutandis to the sub-delegate.

(5) Where the law of the jurisdiction where the AIF is authorised or established requires that assets be held in the custody of a local entity and no local entity satisfies the requirements of subparagraph (3)(c), the depositary may delegate the custody of such financial instruments to such a local entity only to the extent required by the law of that jurisdiction and only for as long as there are no local parties that satisfy the delegation requirement but subject to the requirements specified in subparagraph (6).

(6) The requirements referred to in subparagraph (5) are—

- (a) the investors of the relevant AIF must be duly informed that such delegation is required owing to legal constraints under the law of the jurisdiction where the relevant AIF is authorised or established, and of the circumstances justifying its delegation prior to their investment; and
- (b) the AIF, or AIFM on behalf of the AIF, must instruct the depositary to delegate the custody of such financial instruments to such local entity.

(7) Schedule II applies in respect of the obligations of a depositary under this paragraph.

#### **Depositary liability for loss of financial instrument**

33 (1) This paragraph applies where a financial instrument, held in custody in accordance with these Rules by a depositary, delegate, or sub-delegate, is lost.

(2) Subject to subparagraphs (3) and (4), where a financial instrument has been lost, the depositary must return a financial instrument of identical type or the corresponding amount to the AIF, or the AIFM acting on behalf of the AIF, without undue delay.

(3) The depositary is not required to comply with the obligations in subparagraph (2) if it can prove that the loss occurred owing to an external event beyond the depositary's reasonable control.

(4) In the case of the loss of a financial instrument held in custody by a delegate, the depositary is not required to comply with the obligation in subparagraph (2) if—



- (a) the conditions around delegation of custody were met in accordance with these Rules;
- (b) a written contract between a depositary and the delegate expressly transfers the liability of the depositary to that third party and makes it possible for the AIF, or the AIFM acting on behalf of the AIF, to make a claim against the delegate in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf; and
- (c) a written contract between the depositary and the AIF, or the AIFM acting on behalf of the AIF, expressly discharges the depositary of their liability and establishes an objective reason for such discharge.

(5) Irrespective of any contractual arrangements that provide otherwise, the obligation of the depositary under subparagraph (2) or any liability of the depositary under subparagraph (4)(b) is not affected by any delegation or sub-delegation under these Rules.

(6) Schedule II applies in respect of the obligations of a depositary under this paragraph.

#### **Depositary liability for other losses**

34 (1) If an AIF, or investors of an AIF, have suffered losses other than the loss referred to in paragraph 33, the depositary is liable to the AIF, or investors of the AIF, if the losses are a result of the depositary's negligent or intentional failure to comply with a provision that applies to it.

(2) Irrespective of any contractual arrangements that provide otherwise, any liability of the depositary to the AIF, or to investors of the AIF, under subparagraph (1) is not affected by any delegation by the depositary of its functions.

(3) Schedule II applies in respect of the liabilities of a depositary as set out under this paragraph.

#### **Liability and overseas depositaries**

35 (1) This paragraph applies where—

- (a) the law of the jurisdiction where the AIF is authorised or established requires certain financial instruments to be in held custody by a local entity; and
- (b) there is no local entity that satisfies the delegation requirements in these Rules.

(2) The depositary is not liable for a failure to comply with the obligation under paragraph 33(2), provided that the following conditions are met—

- (a) the constitutional instruments of the AIF concerned expressly allow for a discharge of the obligation;
- (b) the investors of the AIF were informed of the discharge and of the circumstances justifying it prior to their investment;
- (c) the AIF, or the AIFM on behalf of the AIF, instructed the depositary to delegate the custody of the financial instruments to a local entity;
- (d) a written contract between the depositary and the AIF, or the AIFM acting on behalf of the AIF, expressly allows for such a discharge; and
- (e) a written contract between the depositary and the local entity expressly transfers the depositary's liability to the third party making it possible for the AIF, or the AIFM acting on behalf of the AIF, to make a claim against the local entity with regards to loss of financial instruments or the depositary to make such a claim on their behalf.

*Transparency requirements*

**Annual report**

36 (1) An AIFM shall, in such form that the Authority may require, for each AIF that it manages and markets, prepare an annual report (the "annual report") for each financial year which shall be submitted to the Authority no later than 6 months following the end of the relevant financial year of the AIF.

(2) The annual report shall, where applicable, be submitted to the competent authority of the jurisdiction where the AIF is authorised or established.

(3) The annual report shall be provided to investors of the relevant AIF upon request made to the AIFM.

(4) The AIFM shall ensure that the information provided in the annual report is presented in a form that provides materially relevant, reliable, comparable and clear information relating to each AIF.

(5) The annual report must contain all information investors require in relation to AIF structures managed by the AIFM.

(6) In addition to the information required in subparagraph (5), the annual report shall comprise—

- (a) a balance-sheet or a statement of assets and liabilities;
- (b) an income and expenditure account for the financial year;
- (c) a report on the activities of the financial year;

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- (d) written confirmation of any material changes in the information required to be disclosed to investors of the AIF by these Rules during the financial year covered by the report;
- (e) written confirmation of the total amount of remuneration for the financial year, divided into fixed and variable remuneration, paid by the AIFM to its staff, and number of beneficiaries, and, where relevant, carried interest paid by the AIF;
- (f) a description of the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

(7) The accounting information provided in the annual report must be prepared in accordance with the accounting standards set out in subparagraph (8) in the case of a Bermuda authorised or established AIF, or prepared in accordance with the requirements of the jurisdiction where the AIF is authorised or established.

(8) The standards referred to in subparagraph (7) are—

- (a) Intentional Financial Reporting Standards (“IFRS”);
- (b) generally accepted accounting principles (“GAAP”) that apply in Bermuda, Canada, the United Kingdom or the United States of America; or
- (c) such other GAAP as the Authority may recognise.

(9) The accounting information provided in the annual report is required to be audited by one or more persons authorised in accordance with the law of the jurisdiction where the AIF is authorised or established.

(10) Every person authorised to provide accounting information in accordance with subparagraph (9) shall also provide a written report (the “auditor’s report”) to the AIFM prior to the submission of the annual report by the AIFM to the Authority.

(11) The auditor’s report required in accordance with subparagraph (10), which shall include any qualifications made by the auditor, must be reproduced in full in the annual report.

**Disclosure to investors**

37 (1) An AIFM shall, for each of the AIFs that it manages and markets, make available to the AIF investors the information prescribed in paragraph 38.

(2) The information should be disclosed in accordance with the constitution and prospectus of the AIF and at a minimum, at the same time as the annual report is made available to investors.

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(3) An AIFM shall inform the investors of such information before investing in the AIF and upon any material change thereof.

(4) An AIFM shall inform the investors, before they invest in the AIF, of any arrangement made by the depositary to contractually discharge itself of liability under paragraph 33.

(5) An AIFM shall also inform investors of the AIF of any changes with respect to depositary liability without delay.

(6) Where an AIF is required to publish a prospectus in accordance with the IFA or in accordance with the law of the jurisdiction where it is authorised or established, only such information referred to in this paragraph and paragraph 38 which is in addition to that contained in the prospectus shall be disclosed separately or as additional information in the prospectus.

(7) An AIFM shall, for each of the AIFs it manages or markets, periodically disclose the following information to investors of the relevant AIF—

- (a) the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature;
- (b) any new arrangements for managing the liquidity of the AIF;
- (c) the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks.

(8) An AIFM managing AIFs employing leverage must periodically disclose to investors of the relevant AIF the following for each AIF within the time periods specified—

- (a) without undue delay, any changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any right of the re-use of collateral or any guarantee granted under the leverage arrangement;
- (b) the total amount of leverage employed by the AIF in accordance with the constitution and prospectus of the AIF and at least at the same time as the annual report is made available to investors.

**Prescribed information**

38 For the purposes of paragraph 37(6), the following information is prescribed—

- (a) a description of the investment strategy and objectives of the AIF;
- (b) information on where any master AIF is authorised or established, and where the underlying funds are authorised or established, if the AIF is a fund of funds;
- (c) a description of the types of assets in which the AIF may invest;

- (d) the techniques the AIF may employ and all associated risks;
- (e) any applicable investment restrictions;
- (f) the circumstances in which the AIF may use leverage;
- (g) the types and sources of leverage permitted and the associated risks;
- (h) any restrictions on the use of leverage and any collateral and asset re-use arrangements;
- (i) the maximum level of leverage which the AIFM is entitled to employ on behalf of the AIF;
- (j) a description of the procedures by which the AIF may change its investment strategy or investment policy, or both;
- (k) a description of the main legal implications of the contractual relationship entered into for the purpose of investment, including information on—
  - (i) the jurisdiction;
  - (ii) the applicable law;
  - (iii) the existence or not of any legal instruments providing for the recognition and enforcement of judgments in the jurisdiction where the AIF is authorised or established;
  - (iv) the identity of the AIFM, the AIF's depositary, auditor and any other service providers, and a description of their duties and the investors' rights;
- (l) a description of how the AIFM is complying with the requirements of paragraph 9 regarding professional liability risks;
- (m) a description of any delegated management function (portfolio or risk management) by the AIFM, and any safe-keeping function delegated by the depositary including identification of the delegate and any conflicts of interest that may arise from such delegations;
- (n) a description of the AIF's valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets in accordance with paragraph 17;
- (o) a description of the AIF's liquidity risk management, including the redemption both in normal and in exceptional circumstances, and the existing redemption arrangements with investors;
- (p) a description of all fees, charges and expenses and of the maximum amounts thereof which are directly or indirectly borne by investors;

- (q) a description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investors who obtain such preferential treatment and, where relevant, their legal or economic links with the AIF or AIFM;
- (r) the most recent annual report prepared in accordance with paragraph 36;
- (s) the procedure and conditions for the issue and sale of units or shares;
- (t) the latest net asset value of the AIF or the latest market price of the unit or share of the AIF, in accordance with paragraph 17 on valuation principles;
- (u) where available, the historical performance of the AIF;
- (v) the identity of any prime broker and a description of any material arrangements of the AIF with its prime brokers;
- (w) the way the conflicts of interest are managed in relation to a prime broker;
- (x) provision in the contract between a prime broker and a depositary on the transfer and re-use of AIF assets;
- (y) information about any transfer to the prime broker of any liability of the AIF;
- (z) a description of the means and timing of disclosure of information on periodic disclosures and leverage.

*Supervisory reporting*

**Reporting obligations to the Authority and to other competent authorities**

39 (1) An AIFM must report the following information to the Authority in such manner as the Authority may direct, not later than one month after the end of the reporting periods set out in subparagraph (5)—

- (a) the main instruments in which it is trading, including a break-down of financial instruments and other assets, including the AIF's investment strategies and their geographical and sectoral investment focus;
- (b) the markets of which it is a member or where it actively trades;
- (c) the diversification of the AIF's portfolio it manages, including but not limited to, its principal exposures and most important concentrations.

(2) Where the AIF is a fund of funds, upon written request by the AIFM to the Authority, the reporting periods set out in subparagraph (5) may be extended by up to 15 days by the Authority.

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(3) An AIFM must, for each of the AIFs it manages and markets, report the following information to the Authority in such manner as the Authority may direct, in accordance with the reporting periods set out in subparagraph (5)—

- (a) the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature as disclosed to investors;
- (b) any new arrangements for managing the liquidity of the AIF;
- (c) the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk;
- (d) the current risk profile of the AIF, including—
  - (i) the market risk profile of the investments of the AIF, including the expected return and volatility of the AIF in normal market conditions;
  - (ii) the liquidity profile of the investments of the AIF, including the liquidity profile of the AIF's assets, the profile of redemption terms and the terms of financing provided by counterparties to the AIF;
- (e) information on the main categories of assets in which the AIF is investing, including the corresponding short market value and long market value, the turnover and performance during the reporting period; and
- (f) the results of periodic stress tests, under normal and exceptional circumstances, performed in accordance with paragraphs 14(10) and 15(2).

(4) An AIFM managing AIFs employing leverage on a substantial basis must make available to the Authority—

- (a) the overall level of leverage employed by each AIF it manages;
- (b) a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives;
- (c) the extent to which the AIF's assets have been re-used under leveraging arrangements; and
- (d) the identity of the five largest sources of borrowed cash or securities for each of the AIFs managed or marketed by the AIFM, and the amounts of leverage received from each of those sources for each of those AIFs.

(5) The information required in subparagraph (4) must be reported to the Authority as follows—

- (a) every six months by an AIFM managing portfolios of AIFs whose assets under management in total do not exceed the equivalent of EUR 1 billion, for each of their AIFs;
- (b) on a quarterly basis by an AIFM managing portfolios of AIFs whose assets under management in total exceed the equivalent of EUR 1 billion, for each of their EU AIFs;
- (c) on a quarterly basis by an AIFM which is subject to the requirements referred to in clause (a) of this subparagraph, for each AIF whose assets under management, including any assets acquired through use of leverage, in total exceed the equivalent of EUR 500 million, in respect of that AIF;
- (d) on an annual basis by an AIFM in respect of each unleveraged AIF under its management which, in accordance with its core investment policy, invests in non-listed companies and issuers in order to acquire control.

(6) The Authority may require all or part of the information required in subparagraph (5) to be reported within different time frames and in such manner as the Authority may direct.

(7) The Authority may require an AIFM to provide it with any of the following documents upon request—

- (a) an annual report of each AIF managed by the AIFM for each financial year;
- (b) a list of all AIFs which the AIFM manages on a quarterly basis;
- (c) where necessary, for the effective monitoring of systemic risk, the Authority may require other information to be provided to it on a periodic and ad hoc basis.

(8) For the purposes of this paragraph, “leverage” shall be considered by the Authority to be employed on a substantial basis when the exposure of an AIF (calculated in accordance with the commitment method) exceeds three times its net asset value.

(9) Schedule I applies for the purposes of this paragraph as applicable

#### **AIFMs managing leveraged AIFs**

40 An AIFM shall ensure and demonstrate that the leverage limits set by it for each AIF that it manages are appropriate, and that the AIF complies with such limits at all times.

#### **Limits on leverage**

41 (1) The Authority must—

- (a) assess the risks arising out of the use of leverage by an AIF managed by an AIFM;



- (b) if required, impose the measures in subparagraph (2) on an AIFM, in order to ensure the stability and integrity of the financial system in Bermuda or the jurisdiction where an AIF is authorised or established, and to limit the extent to which the use of leverage by an AIF managed by an AIFM contributes to—
  - (i) the build-up of systemic risk in the financial system; or
  - (ii) the risks of disorderly markets.
- (2) The measures referred to in subparagraph (1)(b) are—
  - (a) to impose limits on the level of leverage that such an AIFM may employ; or
  - (b) to impose other restrictions on the AIFM.
- (3) The Authority may use its powers under sections 20 and 21 of the Act (restriction of licence and revocation of licence, respectively) to impose limits on leverage or other restrictions on an AIFM, but this subparagraph does not limit the powers of the Authority.

*Obligations for AIFMs managing AIFs  
which acquire control of non-listed companies or issuers*

**Ways of acquiring control of shares**

- 42 (1) For the purposes of paragraphs 43 to 46, control of a non-listed company or issuer is acquired in one of the following ways—
- (a) one AIF acquires control individually;
  - (b) two or more AIFs, managed by the same AIFM, acquire control jointly on the basis of an agreement aimed at acquiring such control; or
  - (c) two or more AIFs, managed by two or more AIFMs, acquire control jointly on the basis of an agreement aimed at acquiring such control.
- (2) Paragraphs 43 to 46 do not apply where the non-listed company or issuer is—
- (a) a small or medium-sized enterprise; or
  - (b) a special purpose vehicle with the purpose of holding or administering real estate.
- (3) In this paragraph, “small or medium-sized enterprise” means the category of micro, small and medium-sized enterprises (SMEs), made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding the equivalent

of EUR 50 million or an annual balance sheet total not exceeding the equivalent of EUR 43 million.

**Notification of acquisition or disposal of major holdings and control of non-listed company**

43 (1) When an AIF acquires, disposes of, or holds shares of a non-listed company, the AIFM managing the AIF must notify the Authority in writing of the proportion of voting rights of the non-listed company held by the AIF at any time when that proportion reaches, exceeds or falls below the thresholds of 10%, 20%, 30%, 50% and 75%.

(2) When an AIF acquires control of a non-listed company, the AIFM managing the AIF must notify the following persons of such control—

- (a) the non-listed company;
- (b) the non-listed company's shareholders, of which the identities and addresses are available to the AIFM, or can be made available by the non-listed company or through a register to which AIFM has or can obtain access; and
- (c) the Authority.

(3) The notification required under subparagraphs (1) and (2) must contain the following additional information—

- (a) the resulting voting rights in the non-listed company acquired by the AIF;
- (b) the conditions subject to which control was acquired, information about the identity of the different shareholders involved, any person entitled to exercise voting rights on their behalf and, if applicable, the chain of undertakings through which voting rights are effectively held; and
- (c) the date on which control was acquired.

(4) The AIFM must—

- (a) in its notification to the non-listed company, request the governing body of the non-listed company to inform the employees' representatives or, where there are none, the employees themselves, without undue delay of the acquisition of control by the AIF and of the information in subparagraph (3); and
- (b) use its best efforts to ensure the governing body complies with its request.

(5) The notifications required under this paragraph by an AIFM must be made as soon as possible, and in any event no later than 14 days after the date on which the AIF reaches, exceeds or falls below the relevant threshold, or acquires control over the non-listed company.

**Disclosure in case of acquisition of control**

44 (1) When an AIF acquires control of a non-listed company or an issuer in accordance with paragraph 43, the AIFM managing the AIF must make available the information in subparagraph (2) to—

- (a) the non-listed company or issuer;
- (b) the shareholders of the non-listed company or issuer of which the identities and addresses are available to the AIFM, or can be made available by the non-listed company or issuer or through a register to which the AIFM has or can obtain access; and
- (c) the Authority.

(2) The information referred to in subparagraph (1) is—

- (a) the identity of the AIFM which either individually or in agreement with other AIFMs manages the AIF or AIFs that have acquired control;
- (b) the policy for preventing and managing conflicts of interest, in particular between the AIFM, the AIF or AIFs, and the non-listed company, or the issuer, as applicable;
- (c) the specific safeguards to ensure that any agreement between the AIFM, the AIF or AIFs, the non-listed company and the issuer, as applicable, is concluded at arm's length; and
- (d) the policy for external and internal communication relating to the non-listed company or issuer, in particular as regards employees of the non-listed company or issuer.

(3) The AIFM must—

- (a) in its notification to the non-listed company or issuer, request the governing body of the non-listed company or issuer to give the employees' representatives, or where there are none, the employees themselves, without undue delay the information in subparagraph (2); and
- (b) use its best efforts to ensure that the governing body complies with its request.

**Additional disclosure when control is acquired of non-listed company**

45 (1) When an AIF acquires control of a non-listed company, the AIFM managing the AIF, must ensure that within a period of 28 days starting on the day on which control is acquired, the AIF, or the AIFM acting on behalf of the AIF, discloses its intentions with regard to the matters in subparagraph (2) to—

- (a) the non-listed company; and

- (b) the shareholders of the non-listed company of which the identities and addresses are available to the AIFM, or can be made available by the non-listed company or through a register to which the AIFM has or can obtain access.
- (2) The matters referred to in subparagraph (1) are the future business of the non-listed company and the likely repercussions on employment by the non-listed company, including any material change in the conditions of employment.
- (3) The AIFM must—
- (a) request that the governing body of the non-listed company notify the employees' representatives or, where there are none, the employees themselves, without undue delay, about the AIF's intentions with regard to the matters referred to in subparagraph (2); and
  - (b) use its best efforts to ensure the governing body complies with its request.
- (4) When an AIF acquires control of a non-listed company, the AIFM managing the AIF must provide the Authority and the AIF's investors with information on the financing of the acquisition.

**Annual report of AIFs exercising control of non-listed companies**

- 46 (1) When an AIF acquires control of a non-listed company, the AIFM managing the AIF must, in addition to the information prescribed in paragraph 38, include in the AIF's annual report information prescribed in subparagraph (3) relating to the non-listed company.
- (2) An AIFM shall use its best efforts to ensure that—
- (a) the annual report of the non-listed company contains the information in subparagraph (3); and
  - (b) the report is made available by the governing body of the non-listed company to the employees' representatives or, where there are none, the employees themselves within the period in which the annual report must be prepared.
- (3) The information referred to in subparagraph (1) is—
- (a) a fair review of the development of the non-listed company's business representing the situation at the end of the period covered by the annual report;
  - (b) any important events that have occurred since the end of the financial year;
  - (c) the non-listed company's likely future development; and

- (d) in relation to the non-listed company's acquisition or disposal of its own shares—
  - (i) the reasons for acquisitions made during the financial year;
  - (ii) the number and nominal value or, in the absence of a nominal value, the accountable part of the shares acquired and disposed of during the financial year and the proportion of the subscribed capital which they represent;
  - (iii) in the case of acquisition or disposal for a value, the consideration for the shares; and
  - (iv) the number and nominal value or, in the absence of a nominal value, the accountable part of all the shares acquired and held by the non-listed company and the proportion of the subscribed capital which they represent.

(4) If the information in subparagraph (3) is included in the non-listed company's annual report, the AIFM must make the information available to the investors of the AIF, in so far as it is already available, within six months following the end of the financial year of the AIF, and in any event, no later than the date on which the annual report of the non-listed company must be prepared in accordance with the law applicable in the jurisdiction in which the non-listed company has its registered office.

(5) If the information in subparagraph (3) is included in the AIF's annual report, the AIFM must request and use its best efforts to ensure that the governing body of the non-listed company makes that information available to employees' representatives of the non-listed company or, where there are none, to the employees themselves, no later than six months following the end of the financial year of the AIF.

### **Asset stripping**

47 (1) When an AIF acquires control of a non-listed company or an issuer, for a period of 24 months following the acquisition of control, the AIFM managing the AIF—

- (a) must not facilitate, support or instruct any distribution, capital reduction, share redemption or acquisition by the non-listed company or issuer of its own shares;
- (b) in so far as the AIFM is authorised to vote on behalf of the AIF at the meetings of the governing body of the non-listed company or issuer, must not vote in favour of a distribution, capital reduction, share redemption or acquisition by the non-listed company or issuer of its own shares; and
- (c) in any event, must use its best efforts to prevent distributions, capital reductions share redemptions or the acquisition by the non-listed company or issuer of its own shares.

(2) The obligations imposed on an AIFM under subparagraph (1) shall relate to the following—

- (a) any distribution to shareholders made when on the closing date of the last financial year the net assets as set out in the non-listed company or issuer's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the constitution, on the understanding that where the uncalled part of the subscribed capital is not included in the assets shown in the balance sheet, this amount must be deducted from the amount of subscribed capital;
- (b) any distribution to shareholders the amount of which would exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserves in accordance with the law or the constitution;
- (c) to the extent that acquisitions of own shares are permitted, the acquisitions by the non-listed company, including shares previously acquired by the non-listed company and held by it, and shares acquired by a person acting in his own name but on the non-listed company's behalf, that would have the effect of reducing the net assets below the amount mentioned in clause (a) of this subparagraph.

(3) For the purposes of this paragraph—

- (a) in subparagraph (1), "distribution" means a distribution to shareholders, including a payment of dividends and of interest relating to shares;
- (b) the requirements relating to capital reductions shall not apply on a reduction in the subscribed capital, for which the purpose is to offset losses incurred, or to include sums of money in a non-distributable reserve, provided that the amount of such reserve is not more than 10% of the reduced subscribed capital.

#### **Notification of marketing**

48 (1) Within 14 days of commencement of marketing in an overseas jurisdiction, an AIFM shall notify the Authority in such form as the Authority may direct, and include the information set out in subparagraph (2).

(2) The information referred to in subparagraph (1) is—

- (a) identify the jurisdiction where marketing is to be conducted;
- (b) identify the competent authorities in those jurisdictions to whom the AIF and AIFM shall report;

- (c) state the name and address of the AIFM in respect of each AIF;
- (d) state the name and address of each AIF which the applicant intends to market from within Bermuda and the manner in which it intends to market the AIF; and
- (e) certify that it is permitted to market each AIF in that manner in the jurisdiction concerned.

(3) The relevant AIF or AIFM shall notify the Authority when marketing has ceased in a jurisdiction, or when it is unable to comply with the notification requirements under paragraph 48(1).

#### **Calculation of leverage**

49 For the purposes of these Rules, an AIFM shall calculate leverage for each AIF under management in accordance with the provisions set out in Schedule III.

#### **Calculating assets under management**

50 For the purposes of calculating assets under management as required under these Rules, the AIFM shall include the following—

- (a) AIFs managed by the AIFM for which the AIFM has delegated functions shall be included in the calculation but any portfolio of AIFs that the AIFM is managing under delegation shall be excluded;
- (b) each derivative instrument position, including any derivative embedded in transferable securities, shall be converted into its equivalent position in the underlying assets of that derivative using the conversion methodologies set out in Schedule III and the absolute value of that equivalent position shall then be used for the calculation of the total value of the assets under management;
- (c) where an AIF invests in other AIFs managed by the same externally appointed AIFM, that investment may be excluded from the calculation of the AIFM's assets under management;
- (d) where one compartment within an internally or externally managed AIF invests in another compartment of that AIF, that investment may be excluded from the calculation of the AIFM's assets under management.

#### **Commencement**

51 These Rules shall come into operation on such day as the Chairman may appoint by notice published in the Gazette.

**SCHEDULE I**

(paragraph 39)

**QUANTITATIVE REPORTING REQUIREMENTS OF AIFMS**

For the purposes of reporting under paragraph 39 of the Rules, the following information shall be reported.

**AIFM Specific Information**

Identification of Fund manager

**AIF Quarterly Information (paragraph 39(7)(b))**

Detailed list of all AIFs which the AIFM manages (the following information should be reported per AIF which is under management of the AIFM)—

- (a) Identification of AIF;
- (b) Fund identification code(s);
- (c) Inception date of AIF;
- (d) An indication of the AIF type i.e. Hedge Fund; Private Equity; Real Estate; Fund of Funds; ILS; Other;
- (e) NAV;
- (f) Base currency of the AIF according to ISO 4217 and assets under management as calculated under the Rules;
- (g) An indication as to whether the AIF is authorised or established in the EU and information with regard to that status.

**AIF General Information (paragraph 39(5))**

- (a) Domicile of the AIF;
- (b) Identification of prime broker(s) of the AIF.

**Principal markets/instruments in which it trades on behalf of the AIFs it manages (paragraph 39(1))**

From the most important market/instrument to the fifth most important market/instrument—

- (a) The principal markets in which the AIFM trades on behalf of the AIFs it manages;
- (b) The principal instruments in which it trades on behalf of the AIFs it manages;
- (c) Values of assets under management for all AIFs managed, calculated as set out in the Rules.

**Investment details (paragraph 39(1) and (3))**

- (a) Jurisdictions of the three main funding sources (excluding units or shares of the AIF bought by investors);
- (b) Predominant AIF type;
- (c) Main instruments in which the AIF is trading from the most important instrument to the fifth most important instrument, including information on: the type of instrument/instrument code; value; indication of long/short positions;



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- (d) Breakdown of investment strategies for the predominant AIF type including the strategy that best describes the AIF's strategy and the percentage share of the NAV;
- (e) A geographical breakdown of the investments held by the AIF by percentage of the total NAV of the AIF;
- (f) A breakdown of the ten principal exposures of the AIF at the reporting date including information on: type of asset/liability; name/description of the asset/liability; value as calculated in accordance with the Rules; percentage of gross market value; long/short position; counterparty (where relevant);
- (g) A breakdown of the five most important portfolio concentrations including information, such as: type of asset/liability; name/description of the market; value of the aggregate exposure as calculated in accordance with the Rules; percentage of gross market value; long/short position; counterparty (where relevant);
- (h) Typical deal/position size;
- (i) Principal markets in which AIF trades taking into account size of exposure;
- (j) A breakdown of information on investor concentration, such as: the percentage of the AIF's equity that is beneficially owned by the five beneficial owners that have the largest equity interest in the AIF (look through to beneficial owners); percentage breakdown of investor concentration by status of investor; indication as to whether the client is professional/retail;
- (k) Information on the instruments traded and individual exposures in which the AIFM is trading, including details on the main categories of assets (as determined by the Authority) in which the AIF invested as at the reporting date;
- (l) Currency exposure (total long and short value of exposures) by currency group.

**Risk Related Information (paragraph 39(1) and (3))**

- (a) Value of turnover in each asset class over the reporting months;
- (b) Information on each company over which the AIF has a dominant influence, such as: the name; percentage of voting rights; transaction type;
- (c) Expected annual investment return/IRR in normal market conditions (in percentage);
- (d) Information on trading and clearing mechanisms, such as: estimate percentage (in terms of market value) of securities traded; estimated percentage (in terms of trade volumes) of derivatives that are traded; estimate percentage (in terms of trade volumes) of derivatives transactions cleared; estimated percentage (in terms of market value) of repo trades cleared;
- (e) Information on the value of collateral and other credit support that the AIF has posted to all counterparties, such as: value of collateral posited in the form of cash and cash equivalents; value of collateral posited in the form of other securities (excluding cash and cash equivalents); value of other collateral and credit support (including face amount of letters of credit and similar third party credit support);
- (f) Of the amount of collateral and other credit support that the reporting fund has posted to counterparties, the percentage that has been re-hypothecated by counterparties;
- (g) Information on the top five counterparty exposures, such as: identity of the top five counterparties to which the AIF has the greatest mark-to-market net counterparty credit exposure, measured as a % of the NAV of the AIF; identity of the top five counterparties that have the greatest mark-to-market net counterparty credit exposure to the AIF, measured as a % of the NAV of the AIF;

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- (h) An indication as to whether the AIF cleared any transactions directly through a CCP and if so, information on the top three CCPs in terms of value held and net credit exposure;
- (i) Breakdown/profile of investor liquidity, as a percentage of the portfolio capable of being liquidated within the respective prescribed periods of time;
- (j) Value of unencumbered cash;
- (k) Breakdown/profile of investor liquidity, as a percentage of investor equity that can be redeemed within the prescribed periods of time (as a percentage of the AIF's NAV);
- (l) Information as determined by the Authority on investor redemptions;
- (m) Information as determined by the Authority on special arrangements and preferential treatment;
- (n) A breakdown of the ownership of units in the AIF by investor group (as % of NAV of AIF assets; look through to the beneficial owners where known or possible);
- (o) Information on financing of liquidity, such as: the aggregate amount of borrowing by, and cash financing available to, the AIF; information on the prescribed period for which the creditor is contractually committed to provide such financing;
- (p) Information as determined by the Authority on the value of borrowings of cash or securities;
- (q) Information as determined by the Authority on the value of borrowing embedded in financial instruments;
- (r) Information on the five largest sources of borrowed cash or securities (short positions);
- (s) Value of securities borrowed for short positions;
- (t) Gross exposure of financial and/or legal structures controlled by the AIF;
- (u) Leverage of the AIF, as calculated in accordance with the Rules;
- (v) Total number of open positions;
- (w) Information of the historical risk profile per reporting period.

**SCHEDULE II**

(paragraphs 26, 28, 29, 30, 31, 32, 33 and 34)

**OBLIGATIONS OF DEPOSITARIES**

**Contractual particulars**

1. (1) A contract by which the depositary is appointed in accordance with paragraph 26(3) of the Rules should be drawn up between the depositary on the one hand and the AIFM and, as the case may be, or the AIF on the other hand and shall include at least the following elements—

- (a) a description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the AIF may invest and which shall then be entrusted to the depositary;
- (b) a description of the way in which the safe-keeping and oversight function is to be performed depending on the types of assets and the geographical regions in which the AIF plans to invest. With respect to the custody duties this description shall include country lists and procedures for adding and, as the case may be, or withdrawing countries from that list. This shall be consistent with the information provided in the AIF rules, instruments of incorporation and offering documents regarding the assets in which the AIF may invest;
- (c) a statement that the depositary's liability shall not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with paragraphs 32 and 35 of the Rules;
- (d) the period of validity and the conditions for amendment and termination of the contract including the situations which could lead to the termination of the contract and details regarding the termination procedure and, if applicable, the procedures by which the depositary should send all relevant information to its successor;
- (e) the confidentiality obligations applicable to the parties in accordance with relevant laws and regulations. These obligations shall not impair the ability of competent authorities to have access to the relevant documents and information;
- (f) the means and procedures by which the depositary transmits to the AIFM or the AIF all relevant information that it needs to perform its duties, including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate overview of the accounts of the AIF;

- (g) the means and procedures by which the AIFM or the AIF transmits all relevant information or ensures the depositary has access to all the information it needs to fulfil its duties, including the procedures ensuring that the depositary will receive information from other parties appointed by the AIF or the AIFM;
- (h) information on whether or not the depositary, or a third party to whom safe-keeping functions are delegated in accordance with paragraph 32 of the Rules, may re-use the assets it has been entrusted with and, if any, the conditions attached to any such re-use;
- (i) the procedures to be followed when an amendment to the AIF rules, instruments of incorporation or offering documents is being considered, detailing the situations in which the depositary is to be informed, or where the prior agreement of the depositary is needed to proceed with the amendment;
- (j) all necessary information that needs to be exchanged between the AIF, the AIFM, a third party acting on behalf of the AIF or the AIFM, on the one hand, and the depositary, on the other hand, related to the sale, subscription, redemption, issue, cancellation and re-purchase of units or shares of the AIF;
- (k) all necessary information that needs to be exchanged between the AIF, the AIFM, a third party acting on behalf of the AIF or the AIFM and the depositary related to the performance of the depositary's oversight and control function;
- (l) where the parties to the contract envisage appointing third parties to carry out parts of their respective duties, a commitment to provide, on a regular basis, details of any third party appointed and, upon request, information on the criteria used to select the third party and the steps envisaged to monitor the activities carried out by the selected third party;
- (m) information on the tasks and responsibilities of the parties to the contract in respect of obligations relating to the prevention of money laundering and the financing of terrorism;
- (n) information on all cash accounts opened in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF, and the procedures ensuring that the depositary will be informed when any new account is opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF;
- (o) details regarding the depositary's escalation procedures, including the identification of the persons to be contacted within the AIF and, as the case may be, or the AIFM by the depositary when it launches such a procedure;

- (p) a commitment by the depositary to notify the AIFM when it becomes aware that the segregation of assets is not, or is no longer, sufficient to ensure protection from insolvency of a third party to whom safe-keeping functions are delegated in accordance with paragraph 32 of the Rules;
- (q) the procedures ensuring that the depositary, in respect of its duties, has the ability to enquire into the conduct of the AIFM and, as the case may be, or the AIF and to assess the quality of information transmitted, including by way of having access to the books of the AIF and, as the case may be, or AIFM or by way of on-site visits;
- (r) the procedures ensuring that the AIFM and, as the case may be, or the AIF can review the performance of the depositary in respect of the depositary's contractual obligations.

(2) The details of the means and procedures set out in subparagraph (1) shall be described in the contract appointing the depositary or any subsequent amendment to the contract.

(3) The contract appointing the depositary or the subsequent amendment to the contract referred to in subparagraph (2) shall be done in writing.

(4) The parties may agree to transmit all or part of the information that flows between them electronically, provided that proper recording of such information is ensured.

(5) Unless otherwise provided by the law of the jurisdiction applicable, there shall be no obligation to enter into a specific written agreement for each AIF; it shall be possible for the AIFM and the depositary to enter into a framework agreement listing the AIFs managed by that AIFM to which the agreement applies.

(6) The law of the jurisdiction applicable to the contract appointing the depositary and any subsequent agreement shall be specified.

#### **Cash monitoring — general requirements**

2. (1) Where a cash account is maintained or opened at an entity referred to in paragraph 28 of the Rules in the name of the AIF, in the name of the AIFM acting on behalf of the AIF, or in the name of the depositary acting on behalf of the AIF, an AIFM shall ensure that the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations.

(2) In order to have access to all information regarding the AIF's cash accounts and have a clear overview of all the AIF's cash flows, a depositary shall at least—

- (a) be informed, upon its appointment, of all existing cash accounts opened in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF;

- (b) be informed at the opening of any new cash account by the AIF or by the AIFM acting on behalf of the AIF;
- (c) be provided with all information related to the cash accounts opened at a third party entity, directly by those third parties.

**Monitoring of the AIF's cash flows**

3. A depositary shall ensure effective and proper monitoring of the AIF's cash flows and, in particular, it shall at least—

- (a) ensure that all cash of the AIF is booked in accounts opened with entities eligible to be appointed as a depositary in accordance with paragraph 26 of the Rules in the relevant markets where cash accounts are required for the purposes of the AIF's operations and which are subject to prudential regulation and supervision;
- (b) implement effective and proper procedures to reconcile all cash flow movements and perform such reconciliations on a daily basis or, in case of infrequent cash movements, when such cash flow movements occur;
- (c) implement appropriate procedures to identify at the close of business day significant cash flows and, in particular, those which could be inconsistent with the AIF's operations;
- (d) review periodically the adequacy of those procedures including through a full review of the reconciliation process at least once a year and ensuring that the cash accounts opened in the name of the AIF, in the name of the AIFM acting on behalf of the AIF, or in the name of the depositary acting on behalf of the AIF are included in the reconciliation process;
- (e) monitor on an ongoing basis the outcomes of the reconciliations and actions taken as a result of any discrepancies identified by the reconciliation procedures and notify the AIFM if an irregularity has not been rectified without undue delay and also the competent authorities if the situation cannot be clarified and, as the case may be, or corrected;
- (f) check the consistency of its own records of cash positions with those of the AIFM. The AIFM shall ensure that all instructions and information related to a cash account opened with a third party are sent to the depositary, so that the depositary is able to perform its own reconciliation procedure.

**Financial instruments to be held in custody**

4. (1) Financial instruments belonging to the AIF, or to the AIFM acting on behalf of the AIF, which are not able to be physically delivered to the depositary shall be included in

the scope of the custody duties of the depositary where all of the following requirements are met—

- (a) they are transferable securities including those which embed derivatives, money market instruments or units of collective investment undertakings;
- (b) they are capable of being registered or held in an account directly or indirectly in the name of the depositary.

(2) Financial instruments which, in accordance with applicable national law, are only directly registered in the name of the AIF with the issuer itself or its agent, such as a registrar or a transfer agent, shall not be held in custody.

(3) Financial instruments belonging to the AIF, or to the AIFM acting on behalf of the AIF, which are able to be physically delivered to the depositary shall always be included in the scope of the custody duties of the depositary.

**Safekeeping duties with regard to assets held in custody**

5. (1) In order to comply with the obligations laid down in paragraph 29(1) of the Rules with respect to financial instruments to be held in custody, a depositary shall ensure at least that—

- (a) the financial instruments are properly registered in accordance with paragraph 29(3) of the Rules;
- (b) records and segregated accounts are maintained in a way that ensures their accuracy and, in particular, record the correspondence with the financial instruments and cash held for AIFs;
- (c) reconciliations are conducted on a regular basis between the depositary's internal accounts and records and those of any third party to whom custody functions are delegated in accordance with paragraph 32(1) and (2) of the Rules;
- (d) due care is exercised in relation to the financial instruments held in custody in order to ensure a high standard of investor protection;
- (e) all relevant custody risks throughout the custody chain are assessed and monitored and the AIFM is informed of any material risk identified;
- (f) adequate organisational arrangements are introduced to minimise the risk of loss or diminution of the financial instruments, or of rights in connection with those financial instruments as a result of fraud, poor administration, inadequate registering or negligence;
- (g) the AIF's ownership right or the ownership right of the AIFM acting on behalf of the AIF over the assets is verified.

(2) Where a depositary has delegated its custody functions to a delegate in accordance with paragraph 32(1) and (2) of the Rules, it shall remain subject to the requirements of subparagraph (1)(b) to (e). It shall also ensure that the delegate complies with the requirements of subparagraph (1)(b) to (g) and the segregation obligations laid down in this Schedule under the heading 'Segregation Obligations'.

(3) A depositary's safe-keeping duties as referred to in subparagraphs (1) and (2) shall apply on a look-through basis to underlying assets held in accordance with or by financial arrangements and any legal structures controlled directly or indirectly by the AIF or the AIFM acting on behalf of the AIF. The requirement referred to in subparagraph (1) shall not apply to fund of funds structures or master-feeder structures where the underlying funds have a depositary which keeps in custody the assets of these funds.

**Safekeeping duties regarding ownership verification and record-keeping**

6. (1) In order to comply with the obligations referred to in paragraphs 30(1), (2), (3) and (4) of the Rules, a depositary shall at least—

- (a) have access without undue delay to all relevant information it needs in order to perform its ownership verification and record-keeping duties, including relevant information to be provided to the depositary by third parties;
- (b) possess sufficient and reliable information for it to be satisfied of the AIF's ownership right, or of the ownership right of the AIFM acting on behalf of the AIF, over the assets;
- (c) maintain a record of those assets for which it is satisfied that the AIF, or the AIFM acting on behalf of the AIF, holds the ownership. In order to comply with this obligation, the depositary shall—
  - (i) register in its record, in the name of the AIF, assets, including their respective notional amounts, for which it is satisfied that the AIF or the AIFM acting on behalf of the AIF holds the ownership;
  - (ii) be able to provide at any time a comprehensive and up-to-date inventory of the AIF's assets, including their respective notional amounts.

(2) For the purpose of subparagraph (1), the depositary shall ensure that there are procedures in place so that registered assets cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions and the depositary shall have access without undue delay to documentary evidence of each transaction and position from the relevant third party. The AIFM shall ensure that the relevant third party provides the depositary, without undue delay, with certificates or other documentary evidence every time there is a sale or acquisition of assets or a corporate action resulting in the issue of financial instruments and at least once a year.



(3) In any event, a depositary shall ensure that the AIFM has and implements appropriate procedures to verify that the assets acquired by the AIF it manages are appropriately registered in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF, and to check the consistency between the positions in the AIFM's records and the assets for which the depositary is satisfied that the AIF, or the AIFM acting on behalf of the AIF, holds the ownership. The AIFM shall ensure that all instructions and relevant information related to the AIF's assets are sent to the depositary, so that the depositary is able to perform its own verification or reconciliation procedure.

(4) A depositary shall set up and implement an escalation procedure for situations where an anomaly is detected, including notification of the AIFM and of the competent authorities if the situation cannot be clarified and, as the case may be, or corrected.

(5) A depositary's safe-keeping duties referred to in subparagraphs (1) to (4) shall apply on a look-through basis to underlying assets held in accordance with or by financial arrangements and any legal structures established by the AIF, or by the AIFM acting on behalf of the AIF, for the purposes of investing in the underlying assets and which are controlled directly or indirectly by the AIF, or by the AIFM acting on behalf of the AIF. The requirement referred to in subparagraph (1) shall not apply to fund of funds structures and master-feeder structures where the underlying funds have a depositary which provides ownership verification and record-keeping functions for this fund's assets.

**Oversight duties — general requirements**

7. (1) At the time of its appointment, the depositary shall assess the risks associated with the nature, scale and complexity of the AIF's strategy and the AIFM's organisation in order to devise oversight procedures which are appropriate to the AIF and the assets in which it invests and which are then implemented and applied. Such procedures shall be regularly updated.

(2) In performing its oversight duties under paragraph 31 of the Rules, a depositary shall perform ex-post controls and verifications of processes and procedures that are under the responsibility of the AIFM, the AIF or an appointed third party. The depositary shall in all circumstances ensure that an appropriate verification and reconciliation procedure exists which is implemented and applied and frequently reviewed. The AIFM shall ensure that all instructions related to the AIF's assets and operations are sent to the depositary, so that the depositary is able to perform its own verification or reconciliation procedure.

(3) A depositary shall establish a clear and comprehensive escalation procedure to deal with situations where potential irregularities are detected in the course of its oversight duties, the details of which shall be made available to the competent authorities of the AIFM upon request.

**Duties regarding subscription and redemptions**

8. (1) In order to comply with paragraph 31 of the Rules, the depositary shall meet the following requirements—

- (a) the depositary shall ensure that the AIF, the AIFM or the designated entity has established, implements and applies an appropriate and consistent procedure to—
  - (i) reconcile the subscription orders with the subscription proceeds, and the number of units or shares issued with the subscription proceeds received by the AIF;
  - (ii) reconcile the redemption orders with the redemptions paid, and the number of units or shares cancelled with the redemptions paid by the AIF;
  - (iii) verify on a regular basis that the reconciliation procedure is appropriate;
- (b) for the purposes of clause (a)(i), (ii) and (iii), the depositary shall, in particular, regularly check the consistency between the total number of units or shares in the AIF's accounts and the total number of outstanding shares or units that appear in the AIF's register.

(2) A depositary shall ensure and regularly check that the procedures regarding the sale, issue, re-purchase, redemption and cancellation of shares or units of the AIF comply with the applicable national law, and with the AIF rules or instruments of incorporation, and verify that these procedures are effectively implemented.

(3) The frequency of the depositary's checks shall be consistent with the frequency of subscriptions and redemptions.

**Duties regarding the valuation of shares/units**

9. (1) In order to comply with paragraph 31 of the Rules, the depositary shall—

- (a) verify on an ongoing basis that appropriate and consistent procedures are established and applied for the valuation of the assets of the AIF in compliance with paragraph 17(1) of the Rules and its implementing measures and with the AIF rules and instruments of incorporation; and
- (b) ensure that the valuation policies and procedures are effectively implemented and periodically reviewed.

(2) A depositary's procedures shall be conducted at a frequency consistent with the frequency of the AIF's valuation policy as defined in paragraph 17(1) of the Rules and its implementing measures.

(3) Where a depositary considers that the calculation of the value of the shares or units of the AIF has not been performed in compliance with applicable law or the AIF rules or paragraph 17(1) of the Rules, it shall notify the AIFM and, as the case may be, or the AIF and ensure that timely remedial action is taken in the best interest of the investors in the AIF.

(4) Where an external valuer has been appointed, a depositary shall check that the external valuer's appointment is in accordance with paragraph 18 of the Rules and its implementing measures.

**Duties regarding the carrying out of the AIFM's instructions**

10. In order to comply with paragraph 31 of the Rules, the depositary shall at least—

- (a) set up and implement appropriate procedures to verify that the AIF and AIFM comply with applicable laws and regulations and with the AIF's rules and instruments of incorporation. In particular, the depositary shall monitor the AIF's compliance with investment restrictions and leverage limits set in the AIF's offering documents. Those procedures shall be proportionate to the nature, scale and complexity of the AIF;
- (b) set up and implement an escalation procedure where the AIF has breached one of the limits or restrictions referred to in clause (a).

**Duties regarding the timely settlement of transactions**

11. (1) In order to comply with paragraph 31 of the Rules, the depositary shall set up a procedure to detect any situation where a consideration related to the operations involving the assets of the AIF, or of the AIFM acting on behalf of the AIF, is not remitted to the AIF within the usual time limits, notify the AIFM and, where the situation has not been remedied, request the restitution of the financial instruments from the counterparty where possible.

(2) Where transactions do not take place on a regulated market, the usual time limits shall be assessed with regard to the conditions attached to the transactions (OTC derivative contracts or investments in real estate assets or in privately held companies).

**Duties related to the AIF's income distribution**

12. (1) In order to comply with paragraph 31 of the Rules, the depositary shall—

- (a) ensure that the net income calculation, once declared by the AIFM, is applied in accordance with the AIF rules, instruments of incorporation and applicable national law;
- (b) ensure that appropriate measures are taken where the AIF's auditors have expressed reserves on the annual financial statements. The AIF, or the

AIFM acting on behalf of the AIF, shall provide the depositary with all information on reserves expressed on the financial statements; and

- (c) check the completeness and accuracy of dividend payments, once they are declared by the AIFM, and, where relevant, of the carried interest.

(2) Where a depositary considers that the income calculation has not been performed in compliance with applicable law or with the AIF rules or instruments of incorporation, it shall notify the AIFM and, as the case may be, or the AIF and ensure that timely remedial action has been taken in the best interest of the AIF's investors.

### **Due diligence**

13. (1) In order to fulfil the obligations laid down in paragraph 32(2)(c) of the Rules, the depositary shall implement and apply an appropriate documented due diligence procedure for the selection and ongoing monitoring of the delegate. That procedure shall be reviewed regularly, at least once a year, and made available upon request to competent authorities.

(2) When selecting and appointing a delegate to whom safe-keeping functions are delegated in accordance with paragraph 32 of the Rules, the depositary shall exercise all due skill, care and diligence to ensure that entrusting financial instruments to this delegate provides an adequate standard of protection. It shall at least—

- (a) assess the regulatory and legal framework, including country risk, custody risk and the enforceability of the delegate's contracts. That assessment shall, in particular, enable the depositary to determine the potential implication of an insolvency of the third party for the assets and rights of the AIF. If a depositary becomes aware that the segregation of assets is not sufficient to ensure protection from insolvency because of the law of the country where the delegate is located, it shall immediately inform the AIFM;
- (b) assess whether the delegate's practice, procedures and internal controls are adequate to ensure that the financial instruments of the AIF, or of the AIFM acting on behalf of the AIF, are subject to a high standard of care and protection;
- (c) assess whether the delegate's financial strength and reputation are consistent with the tasks delegated. That assessment shall be based on information provided by the potential third party as well as other data and information, where available;
- (d) ensure that the delegate has the operational and technological capabilities to perform the delegated custody tasks with a satisfactory degree of protection and security.

(3) A depositary shall exercise all due skill, care and diligence in the periodic review and ongoing monitoring to ensure that the delegate continues to comply with the criteria and the conditions set out in paragraph 32 of the Rules. To this end, the depositary shall at least—

- (a) monitor the delegate's performance and its compliance with the depositary's standards;
- (b) ensure that the delegate exercises a high standard of care, prudence and diligence in the performance of its custody tasks and, in particular, that it effectively segregates the financial instruments in line with the requirements of this Schedule under paragraph 14;
- (c) review the custody risks associated with the decision to entrust the assets to the delegate and without undue delay notify the AIF or AIFM of any change in those risks. That assessment shall be based on information provided by the third party and other data and information where available. During market turmoil or when a risk has been identified, the frequency and the scope of the review shall be increased. If the depositary becomes aware that the segregation of assets is no longer sufficient to ensure protection from insolvency because of the law of the country where the third party is located, it shall immediately inform the AIFM.

(4) Where the delegate further delegates any of the functions delegated to it, the conditions and criteria set out in subparagraphs (1), (2) and (3) shall apply mutatis mutandis.

(5) A depositary shall monitor compliance with paragraph 27(1) of the Rules.

(6) A depositary shall devise contingency plans for each market in which it appoints a delegate in accordance with paragraph 32 of the Rules, to perform safe-keeping duties. Such a contingency plan shall include the identification of an alternative provider, if any.

(7) A depositary shall take measures, including termination of the contract, which are in the best interest of the AIF and its investors where the delegate no longer complies with the requirements.

### **Segregation obligations**

14. (1) Where safe-keeping functions have been delegated wholly or partly to a delegate, a depositary shall ensure that the delegate to whom safe-keeping functions are delegated pursuant to paragraph 32 of the Rules acts in accordance with the segregation obligation laid down in paragraph 32(3)(c) of the Rules by verifying that the delegate—

- (a) keeps such records and accounts as are necessary to enable it at any time and without delay to distinguish assets of the depositary's AIF clients from its own assets, assets of its other clients, assets held by the depositary for

its own account and assets held for clients of the depositary which are not AIFs;

- (b) maintains records and accounts in a way that ensures their accuracy and, in particular, their correspondence to the assets safe-kept for the depositary's clients;
- (c) conducts, on a regular basis, reconciliations between its internal accounts and records and those of the third party to whom it has delegated safe-keeping functions in accordance with paragraph 32(2)(c) of the Rules;
- (d) introduces adequate organisational arrangements to minimise the risk of loss or diminution of financial instruments or of rights in connection with those financial instruments as a result of misuse of the financial instruments, fraud, poor administration, inadequate record-keeping or negligence;
- (e) where the third party is an entity which is subject to effective prudential regulation and supervision that has the same effect as Bermuda and is effectively enforced, the depositary shall take the necessary steps to ensure that the AIF's cash is held in an account or accounts in accordance with paragraph 28(1) to (3) of the Rules.

(2) Where a depositary has delegated its custody functions to a delegate in accordance with paragraph 32 of the Rules, the monitoring of the delegate's compliance with its segregation obligations shall ensure that the financial instruments belonging to its clients are protected from any insolvency of that delegate. If, according to the applicable law, including in particular the law relating to property or insolvency, the requirements laid down in subparagraph (1) are not sufficient to achieve that objective, the depositary shall assess what additional arrangements are to be made in order to minimise the risk of loss and maintain an adequate standard of protection.

(3) Subparagraphs (1) and (2) shall apply mutatis mutandis when the delegate, to whom safe-keeping functions are delegated in accordance with paragraph 32 of the Rules, has decided to delegate all or part of its safe-keeping functions to another sub-delegate pursuant to paragraph 32(2)(c) of the Rules.

#### **Loss of a financial instrument held in custody**

15. (1) A loss of a financial instrument held in custody within the meaning of paragraph 33 of the Rules shall be deemed to have taken place when, in relation to a financial instrument held in custody by the depositary or by a delegate to whom the custody of financial instruments held in custody has been delegated, any of the following conditions is met—

- (a) a stated right of ownership of the AIF is demonstrated not to be valid because it either ceased to exist or never existed;

- (b) the AIF has been definitively deprived of its right of ownership over the financial instrument;
- (c) the AIF is definitively unable to directly or indirectly dispose of the financial instrument.

(2) The ascertainment by the AIFM of the loss of a financial instrument shall follow a documented process readily available to the competent authorities. Once a loss is ascertained, it shall be notified immediately to investors in a durable medium.

(3) A financial instrument held in custody shall not be deemed to be lost within the meaning of paragraph 33 of the Rules where an AIF is definitively deprived of its right of ownership in respect of a particular instrument, but this instrument is substituted by or converted into another financial instrument or instruments.

(4) In the event of insolvency of the delegate to whom the custody of financial instruments held in custody has been delegated, the loss of a financial instrument held in custody shall be ascertained by the AIFM as soon as one of the conditions listed in subparagraph (1) is met with certainty. There shall be certainty as to whether any of the conditions set out in subparagraph (1) is fulfilled at the latest at the end of the insolvency proceedings. The AIFM and the depositary shall monitor closely the insolvency proceedings to determine whether all or some of the financial instruments entrusted to the third party to whom the custody of financial instruments has been delegated are effectively lost.

(5) A loss of a financial instrument held in custody shall be ascertained irrespective of whether the conditions listed in subparagraph (1) are the result of fraud, negligence or other intentional or non-intentional behaviour.

#### **Depositary liability discharge for other losses**

16. (1) A depositary's liability under paragraph 34(2) of the Rules shall not be triggered, provided the depositary can prove that all the following conditions are met—

- (a) the event which led to the loss is not the result of any act or omission of the depositary or of a delegate to whom the custody of financial instruments held in custody in accordance with paragraph 29(1) of the Rules has been delegated;
- (b) the depositary could not have reasonably prevented the occurrence of the event which led to the loss despite adopting all precautions incumbent on a diligent depositary as reflected in common industry practice;
- (c) despite rigorous and comprehensive due diligence, the depositary could not have prevented the loss.

(2) The requirements referred to in subparagraph (1)(a) and (b) may be deemed to be fulfilled in the following circumstances—

- (a) natural events beyond human control or influence;
- (b) the adoption of any law, decree, regulation, decision or order by any government or governmental body, including any court or tribunal, which impacts the financial instruments held in custody;
- (c) war, riots or other major upheavals.

(3) The requirements referred to subparagraph (1)(a) and (b) shall not be deemed to be fulfilled in cases such as an accounting error, operational failure, fraud, failure to apply the segregation requirements at the level of the depositary or a third party to whom the custody of financial instruments held in custody in accordance with paragraph 29(1) of the Rules has been delegated.

(4) A depositary's liability under paragraph 34(2) of the Rules is not triggered when the depositary has ensured that the depositary and the delegate to whom the custody of financial instruments held in custody in accordance with paragraph 29(1) of the Rules has been delegated have taken all of the following actions—

- (a) establishing, implementing, applying and maintaining structures and procedures, and ensuring expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF in order to identify in a timely manner and monitor on an ongoing basis external events which may result in loss of a financial instrument held in custody;
- (b) assessing on an ongoing basis whether any of the events identified under clause (a) presents a significant risk of loss of a financial instrument held in custody;
- (c) informing the AIFM of the significant risks identified and taking appropriate actions, if any, to prevent or mitigate the loss of financial instruments held in custody, where actual or potential external events have been identified which are believed to present a significant risk of loss of a financial instrument held in custody.

(5) This paragraph shall apply mutatis mutandis to the delegate when the depositary has contractually transferred its liability in accordance with paragraphs 33 and 35 of the Rules.

**Objective reasons for the depositary to contract a discharge of liability**

17. (1) The objective reasons for contracting a discharge pursuant to paragraphs 33 and 34 of the Rules shall be—

- (a) limited to precise and concrete circumstances characterising a given activity;
- (b) consistent with the depositary's policies and decisions.



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(2) The objective reasons shall be established each time the depositary intends to discharge itself of liability.

(3) The depositary shall be deemed to have objective reasons for contracting the discharge of its liability in accordance with paragraphs 33 and 34 of the Rules when the depositary can demonstrate that it had no other option but to delegate its custody duties to a delegate. In particular, this shall be the case where—

- (a) the law of a jurisdiction applicable requires that certain financial instruments be held in custody by a local entity and local entities exist that satisfy the delegation criteria laid down in paragraphs 33 and 34 of the Rules; or
- (b) the AIFM insists on maintaining an investment in a particular jurisdiction despite warnings by the depositary as to the increased risk this presents.

### **SCHEDULE III**

(paragraph 49)

#### **CALCULATION OF LEVERAGE**

##### **GENERAL PROVISIONS ON THE CALCULATION OF LEVERAGE**

1. When calculating leverage of an AIF, leverage shall be expressed as the ratio between the exposure of an AIF and its net asset value.
2. AIFMs shall calculate the exposure of the AIFs managed in accordance with the gross method and the commitment method as set out in A and B below.
3. Exposure contained in any financial or legal structures involving third parties controlled by the relevant AIF shall be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. For AIFs whose core investment policy is to acquire control of non-listed companies or issuers, the AIFM shall not include in the calculation of the leverage any exposure that exists at the level of those non-listed companies and issuers provided that the AIF, or the AIFM acting on behalf of the AIF, does not have to bear potential losses beyond its investment in the respective company or issuer.
4. AIFMs shall exclude borrowing arrangements entered into if these are temporary in nature and are fully covered by contractual capital commitments from investors in the AIF.
5. An AIFM shall have appropriately documented procedures to calculate the exposure of each AIF under its management in accordance with the gross method and the commitment method. The calculation shall be applied consistently over time.

##### **Methods of increasing the exposure of an AIF**

6. When calculating exposure, AIFMs shall use the methods set out in Annex I for the situations referred to therein.

##### **Conversion methodologies for derivative instruments**

7. AIFMs shall use the conversion methodologies set out in Annex II for the derivative instruments referred to therein.

##### **A. GROSS METHOD FOR CALCULATING THE EXPOSURE OF THE AIF**

1. The exposure of an AIF calculated in accordance with the gross method shall be the sum of the absolute values of all positions valued in accordance with the Rules and this Schedule. For the calculation of the exposure of an AIF in accordance with the gross method, an AIFM shall—

- (a) exclude the value of any cash and cash equivalents which are highly liquid investments held in the base currency of the AIF, that are readily convertible to a known amount of cash, are subject to an insignificant risk of change in value and provide a return no greater than the rate of a three-month high quality government bond;
- (b) convert derivative instruments into the equivalent position in their underlying assets using the conversion methodologies set out in Annex II and the methods set out in paragraphs (4) to (9) and (14) of Annex I;
- (c) exclude cash borrowings that remain in cash or cash equivalent as referred to in point (a) and where the amounts of that payable are known;
- (d) include exposure resulting from the reinvestment of cash borrowings, expressed as the higher of the market value of the investment realised or the total amount of the cash borrowed as referred to in paragraphs (1) and (2) of Annex I;
- (e) include positions within re-purchase or reverse re-purchase agreements and securities lending or borrowing or other arrangements in accordance with paragraphs (3) and (10) to (13) of Annex I.

**B. COMMITMENT METHOD FOR CALCULATING THE EXPOSURE OF AN AIF**

1. The exposure of an AIF calculated in accordance with the commitment method shall be the sum of the absolute values of all positions valued in accordance with the Rules, subject to the criteria provided for in paragraphs 2 to 9.
2. For the calculation of the exposure of an AIF in accordance with the commitment method, an AIFM shall—
  - (a) convert each derivative instrument position into an equivalent position in the underlying asset of that derivative using the conversion methodologies;
  - (b) apply netting and hedging arrangements;
  - (c) calculate the exposure created through the reinvestment of borrowings where such reinvestment increases the exposure of the AIF as defined in paragraphs (1) and (2) of Annex I;
  - (d) include other arrangements in the calculation in accordance with paragraphs (3) and (10) to (13) of Annex I.
3. For the purposes of calculating the exposure of an AIF according to the commitment method—
  - (a) netting arrangements shall include combinations of trades on derivative instruments or security positions which refer to the same underlying asset,

irrespective — in the case of derivative instruments — of the maturity date of the derivative instruments and where those trades on derivative instruments or security positions are concluded with the sole aim of eliminating the risks linked to positions taken through the other derivative instruments or security positions;

- (b) hedging arrangements shall include combinations of trades on derivative instruments or security positions which do not necessarily refer to the same underlying asset and where those trades on derivative instruments or security positions are concluded with the sole aim of offsetting risks linked to positions taken through the other derivative instruments or security positions.

4. By way of derogation from paragraph 2, a derivative instrument shall not be converted into an equivalent position in the underlying asset if it has all of the following characteristics—

- (a) it swaps the performance of financial assets held in the AIF's portfolio for the performance of other reference financial assets;
- (b) it totally offsets the risks of the swapped assets held in the AIF's portfolio so that the AIF's performance does not depend on the performance of the swapped assets;
- (c) it includes neither additional optional features, nor leverage clauses nor other additional risks as compared to a direct holding of the reference financial assets.

5. By way of derogation from paragraph 2, a derivative instrument shall not be converted into an equivalent position in the underlying asset when calculating the exposure according to the commitment method if it meets both of the following conditions—

- (a) the combined holding by the AIF of a derivative instrument relating to a financial asset and cash which is invested in cash equivalent is equivalent to holding a long position in the given financial asset;
- (b) the derivative instrument shall not generate any incremental exposure and leverage or risk.

6. Hedging arrangements shall be taken into account when calculating the exposure of an AIF only if they comply with all the following conditions—

- (a) the positions involved within the hedging relationship do not aim to generate a return and general and specific risks are offset;
- (b) there is a verifiable reduction of market risk at the level of the AIF;

- (c) the risks linked to derivative instruments, general and specific, if any, are offset;
  - (d) the hedging arrangements relate to the same asset class;
  - (e) the hedging arrangements are efficient in stressed market conditions.
7. Subject to paragraph 6, derivative instruments used for currency hedging purposes and that do not add any incremental exposure, leverage or other risks shall not be included in the calculation.
8. An AIFM shall net positions in any of the following cases—
- (a) between derivative instruments, provided they refer to the same underlying asset, even if the maturity date of the derivative instruments is different;
  - (b) between a derivative instrument whose underlying asset is a transferable security, money market instrument or units, and that same corresponding underlying asset.
9. AIFMs managing AIFs that, in accordance with their core investment policy, primarily invest in interest rate derivatives shall make use of specific duration netting rules in order to take into account the correlation between the maturity segments of the interest rate curve as set out in the duration netting rules set out in paragraph 10.

**Duration netting rules**

10. (1) Duration netting rules shall be applied by AIFMs when calculating the exposure of AIFs according to paragraph 8.
- (2) The duration netting rules shall not be used where they would lead to a misrepresentation of the risk profile of the AIF. AIFMs availing themselves of those netting rules shall not include other sources of risk such as volatility in their interest rate strategy. Consequently, interest rate arbitrage strategies shall not apply those netting rules.
- (3) The use of those duration netting rules shall not generate any unjustified level of leverage through investment in short-term positions. Short-dated interest rate derivatives shall not be the main source of performance for an AIF with medium duration which uses the duration netting rules.
- (4) Interest rate derivatives shall be converted into their equivalent underlying asset position and netted in accordance with Annex III.
- (5) An AIF making use of the duration netting rules may still make use of the hedging framework. Duration netting rules may be applied only to the interest rate derivatives which are not included in hedging arrangements.

***ANNEX I***

**Methods of increasing the exposure of an AIF**

- (1) Unsecured cash borrowings: When cash borrowings are invested they have the propensity to increase the exposure of the AIF by the total amount of those borrowings. Therefore, the minimum exposure is always the amount of the borrowing. It might be higher if the value of the investment realised with the borrowing is greater than the borrowed amount. To avoid double counting, cash borrowings that are used to finance the exposure shall not be included within the calculation. If the cash borrowings are not invested but remain in cash or cash equivalent they will not increase the exposure of the AIF.
- (2) Secured cash borrowings: Secured cash borrowings are similar to unsecured cash borrowings but the loan may be secured by a pool of assets or a single asset. If the cash borrowings are not invested but remain in cash or cash equivalent they will not increase the exposure of the AIF.
- (3) Convertible borrowings: Convertible borrowings are purchased debt which has the ability, under certain circumstances, to enable the holder or issuer to convert that debt into another asset. The exposure of the AIF is the market value of such borrowings.
- (4) Interest rate swaps: An interest rate swap is an agreement to exchange interest rate cash flows, calculated on a notional principal amount, at specified intervals (payment dates) during the life of the agreement. Each party's payment obligation is computed using a different interest rate based on the notional exposures.
- (5) Contracts for differences: A contract for differences (CFD) is an agreement between two parties — the investor and the CFD provider — to pay the other the change in the price of an underlying asset. Depending on which way the price moves, one party pays the other the difference from the time the contract was agreed to the point in time where it ends. Exposure is the market value of the underlying asset. The same treatment must be applied to financial spread bets.
- (6) Futures contracts: A futures contract is an agreement to buy or sell a stated amount of a security, currency, commodity, index or other asset at a specific future date and at a pre-agreed price. The exposure is the market value of the equivalent underlying asset.
- (7) Total return swaps: A total return swap is an agreement in which one party (total return payer) transfers the total economic performance of a reference obligation to the other party (total return receiver). Total economic performance includes income from interest and fees, gains or losses from market movements, and credit losses. The exposure

of the AIF is the market value of the equivalent reference assets which have a bearing on the economic performance of the swap.

(8) Forward agreements: A forward agreement is a customised, bilateral agreement to exchange an asset or cash flows at a specified future settlement date at a forward price agreed on the trade date. One party to the forward is the buyer (long), who agrees to pay the forward price on the settlement date; the other is the seller (short), who agrees to receive the forward price. Entering into a forward contract typically does not require the payment of a fee. The exposure of the AIF is the market value of the equivalent underlying asset. This may be replaced by the notional value of the contract where this is more conservative.

(9) Options: An option is an agreement that gives the buyer, who pays a fee (premium), the right — but not the obligation — to buy or sell a specified amount of an underlying asset at an agreed price (strike or exercise price) on or until the expiration of the contract (expiry). A call option is an option to buy, and a put option an option to sell. The bounds of the exposure of the fund will be on the one side a potential unlimited exposure and on the other side an exposure that is limited to the higher of the premium paid or the market value of that option. The exposure between these two bounds is determined as the delta (an options delta measures the sensitivity of an option's price solely to a change in the price of the underlying asset) adjusted equivalent of the underlying position. The same approach must be adopted for embedded derivatives, e.g. in structured products. The structure should be broken down into its component parts and the effect of layers of derivative exposures must be adequately captured.

(10) Re-purchase agreements: The re-purchase agreement normally occurs where an AIF 'sells' securities to a reverse-repo counterparty and agrees to buy them back at an agreed price in the future. The AIF will incur a financing cost from engaging in this transaction and will therefore need to re-invest the cash proceeds (effectively cash collateral) in order to generate a return greater than the financing cost incurred. This reinvestment of 'cash collateral' means that incremental market risk will be carried by the AIF and consequently must be taken into account in the global exposure calculation. The economic risks and rewards of the 'sold' securities remain with the AIF. Also, a repo transaction will almost always give rise to leverage as the cash collateral will be reinvested. In the event that non-cash collateral is received as part of the transaction and this collateral is further used as part of another repo, or stock-loan agreement, the full market value of the collateral must be included in the global exposure amount. The exposure of the AIF is increased by the reinvested part of the cash collateral.

(11) Reverse re-purchase agreements: This transaction occurs where an AIF 'purchases' securities from a repo counterparty and agrees to sell them back at an agreed price in the future. AIFs normally engage in these transactions to generate a low-risk money-market type return, and the 'purchased' securities act as collateral. Therefore, no global exposure

is generated; nor does the AIF take on the risks and rewards of the 'purchased' securities, i.e. there is no incremental market risk. However, it is possible for the 'purchased' securities to be further used as part of a repo or security-loan transaction, as described above, and in that case the full market value of the securities must be included in the global exposure amount. The economic risks and rewards of the purchased securities remain with the counterparty and therefore this does not increase the exposure of the AIF.

(12) Securities lending arrangements: An AIF engaging in a securities lending transaction will lend a security to a security-borrowing counterparty (who will normally borrow the security to cover a physical short sale transaction) for an agreed fee. The security borrower will deliver either cash or non-cash collateral to the AIF. Only where cash collateral is reinvested in instruments, other than cash or cash equivalent, will global exposure be created. If the non-cash collateral is further used as part of a repo or another security lending transaction, the full market value of the securities must be included in the global exposure amount as described above. Exposure is created to the extent that the cash collateral has been reinvested.

(13) Securities borrowing arrangements: An AIF engaging in the borrowing of securities will borrow a security from a security-lending counterparty for an agreed fee. The AIF will then sell the security in the market. The AIF is now short that security. To the extent that the cash proceeds from the sale are reinvested this will also increase the exposure of the AIF. Exposure is the market value of the shorted securities; additional exposure is created to the extent that the cash received is reinvested.

(14) Credit default swaps: A credit default swap (CDS) is a credit derivative agreement that gives the buyer protection, usually the full recovery, in case the reference entity defaults or suffers a credit event. In return, the seller of the CDS receives from the buyer a regular fee, called the spread. For the protection seller, the exposure is the higher of the market value of the underlying reference assets or the notional value of the credit default swap. For the protection buyer, the exposure is the market value of the underlying reference asset.

## ***ANNEX II***

### **Conversion methodologies for derivative instruments**

(1) The following conversion methods shall be applied to the non-exhaustive list below of standard derivatives—

(a) Futures—

(i) Bond future: Number of contracts \* notional contract size \* market price of the cheapest-to-deliver reference bond;

(ii) Interest rate future: Number of contracts \* notional contract size;



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- (iii) Currency future: Number of contracts \* notional contract size;
  - (iv) Equity future: Number of contracts \* notional contract size \* market price of underlying equity share;
  - (v) Index futures: Number of contracts \* notional contract size \* index level;
- (b) Plain vanilla options (bought/sold puts and calls)—
- (i) Plain vanilla bond option: Notional contract value \* market value of underlying reference bond \* delta;
  - (ii) Plain vanilla equity option: Number of contracts \* notional contract size \* market value of underlying equity share \* delta;
  - (iii) Plain vanilla interest rate option: Notional contract value \* delta;
  - (iv) Plain vanilla currency option: Notional contract value of currency leg(s) \* delta;
  - (v) Plain vanilla index options: Number of contracts \* notional contract size \* index level \* delta;
  - (vi) Plain vanilla options on futures: Number of contracts \* notional contract size \* market value of underlying asset \* delta;
  - (vii) Plain vanilla swaptions: Reference swap commitment conversion amount \* delta;
  - (viii) Warrants and rights: Number of shares/bonds \* market value of underlying referenced instrument \* delta;
- (c) Swaps—
- (i) Plain vanilla fixed/floating rate interest rate and inflation swaps: notional contract value;
  - (ii) Currency swaps: Notional value of currency leg(s);
  - (iii) Cross currency interest rate swaps: Notional value of currency leg(s);
  - (iv) Basic total return swap: Underlying market value of reference asset(s);
  - (v) Non-basic total return swap: Cumulative underlying market value of both legs of the TRS;
  - (vi) Single name credit default swap—
    - (A) Protection seller - The higher of the market value of the underlying reference asset or the notional value of the Credit Default Swap;
    - (B) Protection buyer - Market value of the underlying reference asset;

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- (vii) Contract for differences: Number of shares/bonds \* market value of underlying referenced instrument;
  - (d) Forwards—
    - (i) FX forward: notional value of currency leg(s);
    - (ii) Forward rate agreement: notional value;
  - (e) Leveraged exposure to indices with embedded leverage - A derivative providing leveraged exposure to an underlying index, or indices that embed leveraged exposure to their portfolio, must apply the standard applicable commitment approach to the assets in question.
- (2) The following conversion methods shall be applied to the non-exhaustive list below of financial instruments which embed derivatives—
- (a) Convertible bonds: Number of referenced shares \* market value of underlying referenced shares \* delta;
  - (b) Credit linked notes: Market value of underlying reference asset(s);
  - (c) Partly paid securities: Number of shares/bonds \* market value of underlying referenced instruments;
  - (d) Warrants and rights: Number of shares/bonds \* market value of underlying referenced instrument \* delta.
- (3) List of examples of non-standard derivatives with the related commitment methodology being used—
- (a) Variance swaps: Variance swaps are contracts that allow investors to gain exposure to the variance (squared volatility) of an underlying asset and, in particular, to trade future realised (or historical) volatility against current implied volatility. According to market practice, the strike and the variance notional are expressed in terms of volatility. For the variance notional, this gives—
$$\text{variance notional} = \frac{\text{vega notional}}{2 \text{ strike}}$$
    - (i) The vega notional provides a theoretical measure of the profit or loss resulting from a 1% change in volatility;
    - (ii) As realised volatility cannot be less than zero, a long swap position has a known maximum loss. The maximum loss on a short swap is often limited by the inclusion of a cap on volatility. However without a cap, a short swap's potential losses are unlimited;

- (b) The conversion methodology to be used for a given contract at time  $t$  is—
- (i) Variance notional \* (current) variance $_t$  (without volatility cap);
  - (ii) Variance notional \* min [(current) variance $_t$  volatility cap<sup>2</sup>] (with volatility cap) whereby: (current) variance $_t$  is a function of the squared realised and implied volatility, more precisely—

$$(\text{current}) \text{ variance} = \frac{t}{T} * \text{realized volatility } (0,t)^2 + \frac{T-t}{T} * \text{implied volatility } (t,T)^2$$

- (c) Volatility swaps - by analogy with the variance swaps, the following conversion formulae should be applied to volatility swaps—
- (i) Vega notional \* (current) volatility $_t$  (without volatility cap);
  - (ii) Vega notional \* min [(current) volatility $_t$ ; volatility cap] (with volatility cap) whereby the (current) volatility  $t$  is a function of the realised and implied volatility.

- (4) Barrier (knock-in knock-out) options - Number of contracts \* notional contract size \* market value of underlying equity share \* delta.

### **ANNEX III**

#### **Duration netting rules**

- (1) An interest rate derivative shall be converted into its equivalent underlying asset position in accordance with the following methodology—

The equivalent underlying asset position of each interest rate derivative instrument shall be calculated as its duration divided by the target duration of the AIF and multiplied by the equivalent underlying asset position—

where—

- (a) duration FDI is the duration (sensitivity of the market value of the financial derivative instrument to interest rate movements) of the interest rate derivative instrument;
- (b) duration target is in line with the investment strategy, the directional positions and the expected level of risk at any time and will be regularised otherwise. It is also in line with the portfolio duration under normal market conditions;
- (c) CV derivative is the converted value of the derivative position as defined by the Annex II.

- (2) The equivalent underlying asset positions calculated in accordance with paragraph (1) shall be netted as follows—

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- (a) Each interest rate derivative instrument shall be allocated to the appropriate maturity range of the following maturity-based ladder—  
Maturities ranges—
    - 1. 0 - 2 years
    - 2. 2 - 7 years
    - 3. 7 - 15 years
    - 4. > 15 years
  - (b) The long and short equivalent underlying asset positions shall be netted within each maturity range. The amount of the former which is netted with the latter is the netted amount for that maturity range;
  - (c) Starting with the shortest maturity range, the netted amounts between two adjoining maturity ranges shall be calculated by netting the amount of the remaining unnetted long (or short) position in the maturity range (i) with the amount of the remaining unnetted short (long) position in the maturity range (i + 1);
  - (d) Starting with the shortest maturity range, the netted amounts between two remote maturity ranges separated by another one shall be calculated by netting the amount of the remaining unnetted long (or short) position in the maturity range (i) with the amount of the remaining unnetted short (long) position in the maturity range (i + 2);
  - (e) The netted amount shall be calculated between the remaining unnetted long and short positions of the two most remote maturity ranges.
- (3) The AIF shall calculate its exposures as the sum of absolute values—
- (a) 0% of the netted amount for each maturity range;
  - (b) 40% of the netted amounts between two adjoining maturity ranges (i) and (i + 1);
  - (c) 75% of the netted amounts between two remote maturity ranges separated by another one, meaning maturity ranges (i) and (i + 2);
  - (d) 100% of the netted amounts between the two most remote maturity ranges; and
  - (e) 100% of the remaining unnetted positions.

Made this 27th day of June 2016

Chairman  
The Bermuda Monetary Authority