
Appendix A

Proposed amendments to the Collective Investment Rules relating to the use of prime brokers

13.6 Hedge Funds

13.6.1 This section applies to an Operator of a Domestic Fund which is a Hedge Fund.

Guidance

A Fund of Hedge Funds is a Fund dedicated to investing in a number of Hedge Funds or sub-funds of one or more Hedge Funds (or both).

Risk management and net asset value calculation process

13.6.2 An Operator of a Hedge Fund must ensure that the risks inherent in the operation of a Hedge Fund are adequately addressed, with due regard to the nature of strategies and investment process employed by the Operator and the role of Fund Administrators, Custodians and where appointed, prime brokers.

Guidance

A prime broker is a person who provides to a Fund a range of services including custody and depository services, trading and execution services, clearing and settlement services and financing to support the Fund's investment activities. Such financing activities generally include stock lending and borrowing. The restrictions in CIR App 1.2.2(f) prevent an Operator of a Hedge Fund from authorising a prime broker to commingle the assets of the Fund with any other assets held by or available to the prime broker and use those assets as collateral to support the prime broker's cross lending and borrowing activities involving Funds to which it acts as the prime broker. However, the restrictions in CIR App 1.2.2(f) do not apply if an Operator of a Hedge Fund can comply with the requirements relating to the use of prime brokers set out in Rule 13.6.3.

13.6.3 An Operator of a Hedge Fund may only grant to a prime broker authority to combine the assets of the Fund with any other assets held by or available to the prime broker as collateral for any financing activities to be undertaken by the prime broker where, and so long as, all the following conditions are met:

- (a) the Fund is a Private Fund;
 - (b) the Prospectus of the Fund contains, in addition to the disclosure required under Rule 19, the following mandatory disclosure and warnings:
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- (i) the identity and profile of the prime broker, including where it is located and how it is regulated;
- (ii) the services which the prime broker provides to the Fund and the nature and extent to which the prime broker has the power and authority to combine the assets of the Fund with any other assets held by or available to the prime broker as collateral for any financing activities undertaken by the prime broker; and
- (iii) a prominent health warning in the Prospectus to alert prospective investors to the facts that:
 - (A) the Fund's appointed prime broker has the power and authority to use as collateral the assets of the Fund in conjunction with any other assets held by or available to the prime broker; and
 - (B) where the prime broker uses Fund assets as collateral pursuant to the above power, the investors may lose all the assets of the Fund in the event of the insolvency of the prime broker;
- (c) the person appointed as the prime broker meets the requirements under Rule 6.3.2;
- (d) the agreement between the prime broker and the Operator contains mandatory contractual provisions that:
 - (i) prohibit the prime broker from using as collateral the assets of the Fund to an extent exceeding 140% of the Fund's indebtedness to the prime broker at any given time; and
 - (ii) create an irrevocable right in favour of the Fund that enables any indebtedness of the Fund to the prime broker to be set off against any amounts that are owing by the prime broker to the Fund, including in the event of the insolvency of the prime broker; and
- (e) the Operator has in place adequate valuation procedures to mark positions to market daily in order to meet on an ongoing basis the restriction referred to in (d)(i) relating to the limit to which the prime broker may use as collateral the assets of the Fund.

Guidance

If the prime broker holds the legal title to the Fund assets, the prime broker must, in any event, meet the Eligible Custodian requirements in Rule 6.3.2. However, even if a prime broker does not hold the legal title to the Fund assets, Rule 13.6.3(c) requires it to meet the Eligible Custodian requirements in certain circumstances. This is where it has the power to use Fund assets as collateral for its financing activities (e.g. by having a charge over the Fund assets) in conjunction with any other assets held by or available to it.

13.6.43 An Operator must ensure adequate segregation of duties in the net asset value determination process. The net asset value of the Fund must be produced by parties who are not involved in the investment process of the investment management entity. The Governing Body, Trustee or General Partner of the Fund must ensure independence in practice, which may be achieved by delegating the calculation, determination and production of the net asset value to a suitably competent and experienced third party Fund Administrator.

Guidance

1. In relation to the matters referred to in Rules 13.6.2 and 13.6.3 and in relation to management of Hedge Fund investment, the DFSA expects Operators of Hedge Funds to have proper regard to best practice standards or guidance issued by the DFSA as well as leading international trade bodies in relation to Hedge Funds. The DFSA expects Operators to pay particular attention to the following guidance notes.

Risk management process

2. Risk management is an important part of management of the Fund Property and should be used to help reduce the likelihood of capital loss and failure.
3. The Hedge Fund Operator's risk governance policy should be related to the nature of the Fund's investment and strategy and regularly used by the Hedge Fund Operator and the Hedge Fund Investment Manager to manage and monitor risk. The risk management process should deal with both normal and exceptional conditions and the Operator and the Fund Investment Manager should:
 - (a) identify and understand the sources of risks inherent in their investment styles or process. The Operator should translate such risks into relevant, measurable risk factors;
 - (b) take into account the interaction between different types of risk when considering risk;
 - (c) consider risk factors such as market risk, credit risk, liquidity risk, concentration, and counterparty risk;
 - (d) define their attitude towards risk by documenting investment restrictions and where appropriate, quantitative risk measure limits should also be provided.
 - (e) monitor risk on regular basis; and
 - (f) inform the investment decision makers on a timely basis about the current level of risk in the portfolio.

Valuation and pricing

4. A Hedge Fund Operator should establish a pricing and valuation policy which includes a practical escalation and resolution procedures for the management of exceptions and should ensure:
 - (a) that investment management and portfolio valuation are not undertaken by the same entity;
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- (b) explicit clarification of the role of the Hedge Fund Operator, the Investment Manager, the Fund Administrator, the prime broker and any other party in the valuation process.
- (c) the policy is adequately described in the Prospectus; and
- (d) that valuation statements are provided to every Unitholder on at least a quarterly basis.

Investment strategy and process

5. The investment strategy to be applied by the Hedge Fund Operator or Investment Manager should be clearly articulated to participants and potential participants. This requires adequate disclosure and explanation of how Funds are to be invested, what factors will influence investment performance and what risks are to be associated with a particular investment strategy. The Operator should:
- (a) set out the investment objectives of the strategy;
 - (b) identify any constraints the strategy imposes, e.g. types of products traded, size, amount of leverage, geographical and market limitations, position and risk limits;
 - (c) identify the main risks and evaluate how such risks should be managed (i.e. avoidance, hedging or decision to accept that risk);
 - (d) identify how regulatory and other internal constraints affect the execution of the investment strategy;
 - (e) have due regard to the Prospectus issued in connection with the relevant Hedge Fund and meet the legal or regulatory requirements imposed by the Hedge Fund itself;
 - (f) communicate material changes to the investment strategy to participants on a timely basis;
 - (g) have a defined investment decision making process which imposes an investment management discipline and identifies who has responsibility for making investment decisions and any limits on such authority; overseeing the investment decision process; and monitoring investment decisions against any internally or externally defined limits; and
 - (h) ensure the investment strategy is documented and kept up to date.
6. In its investment strategy and Fund management investment process, the Hedge Fund Operator should disclose to investors a detailed description of each strategy, the intended outcome of the strategy, identification of potential risks in that strategy and how the identified risks will be managed.

Banking arrangements and operational controls

7. A Hedge Fund Operator should ensure that adequate systems and controls are put in place to address the banking arrangements of a Hedge Fund. Controls are critical to the overall control of non-trading activities undertaken by the Fund. The Hedge Fund Operator would normally use Fund Administrators and prime brokers for their cash processing. However, there are key controls that are required to be established by the Operator to enable non-trading controls to be securely handled.
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8. In relation to the above, adequate controls will need to be maintained in respect of the following key activities:
 - (a) bank account opening;
 - (b) transaction authorisation; and
 - (c) bank account reconciliations

Evaluation of prime brokers

9. A Hedge Fund Operator should understand the role of the prime broker and should consider the following factors in evaluating a prime broker and its documentation:
 - (a) the services the prospective prime broker will provide, including value added services and how the prime broker will deliver those services.
 - (b) the extent to which processes of delivery between the Investment Manager and the prime broker are automated;
 - (c) interest rate and fee structure;
 - (d) the cost, financing and securities lending structure;
 - (e) material provisions of the prime brokerage documentation such as margin calls, synthetic products trading, segregation of assets and events of default;
 - (f) the prime broker's familiarity with and appropriate internal resources to service the investment strategy;
 - (g) the amount of leverage the prime broker is prepared to provide and the basis on which this is provided, e.g. the use of a risk based system;
 - (h) the extent of segregation and ownership of assets; and
 - (i) the credit worthiness of the prime broker.

Fund of hedge funds investments

10. The Operator of a Fund of Hedge Funds should undertake due diligence procedures on the underlying Hedge Funds prior to investing in them. In this regard, the Operator should ensure that the underlying Hedge Fund:
 - (a) is domiciled in a jurisdiction which in the Fund Operator's opinion provides adequate regulatory safeguards;
 - (b) is subject to independent audit in accordance with generally accepted international ~~accounting~~ auditing standards;
 - (c) has arrangements in place such that all assets are held by a party or parties independent of the Operator of the Hedge Fund;
 - (d) in its Prospectus includes specific information in respect of the following:
 - (i) the investment policies and the relevant risks associated with those policies;
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- (ii) the levels of leverage employed by the Hedge Fund;
 - (iii) levels of fees charged by the underlying Hedge Fund and how those fees are calculated;
 - (iv) potential liquidity problems;
 - (v) valuation policies and potential valuation difficulties;
 - (vi) an explanation, including a glossary of terms if necessary, of the alternative investment strategies which the underlying Hedge Fund may employ;
- (e) issues valuation statements to investors at regular intervals; and
- (f) has redemption policies which are transparent and provide for reasonable time period between submission of redemption requests and payment of settlement proceeds.
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18.2 Notification

18.2.1 An Operator of a Private Fund must, when notifying the DFSA pursuant to Article 56, also include:

- (a) a general description of the Fund including the nature of its investments and the intended size of the Fund in monetary terms;
- (b) if it is a Hedge Fund and has a prime broker appointed with authority to use as collateral the assets of the Fund in conjunction with any other assets held by or available to the prime broker:
 - (i) the details relating to the identity of the prime broker and its Regulator; and
 - (ii) a legal certification that all the requirements in Rule 13.6.3 relating to the use of prime brokers have been fully complied with by the Operator.

A1.2 Mandatory provisions

A1.2.2 Before an Operator or Trustee passes, or permits to be passed, the property of the Fund to an Eligible Custodian it must have procured a written acknowledgement from the Eligible Custodian stating:

- (a) that the title of the account sufficiently distinguishes that account from any account containing Investments belonging to the Eligible Custodian, and is in the form requested by the Operator or Trustee;
 - (b) that the Fund's Investments will only be credited and withdrawn in accordance with the instructions of the Operator or Trustee;
 - (c) that the Eligible Custodian will hold the Fund's Investments separately from assets belonging to the Eligible Custodian;
 - (d) the arrangements for recording and registering the Funds, claiming and receiving dividends and other entitlements and interest and the giving and receiving of instructions;
 - (e) that the Eligible Custodian will deliver a statement to the Operator or Trustee (including the frequency of such statement), which details the Fund's Investments deposited to the account;
 - (f) subject to A1.2.3, that all the Investments standing to the credit of the account are held by the Operator Eligible Custodian as the agent and by the Trustee on trust of the Operator or the Trustee and that the Eligible Custodian is not entitled to combine the account with any other account or to exercise any charge, mortgage, lien, right of set-off or counterclaim against Investments
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in that account in respect of any sum owed to the Eligible Custodian on any other account of the Operator or Trustee or any other person; and

- (g) the extent of liability of the Eligible Custodian in the event of default.

A1.2.3 An Operator, and if appointed a Trustee, is not required to meet the requirement in A1.2.2(f) above, where either the Eligible Custodian or any other person acting as the prime broker of the Fund does so in compliance with the requirements in Rule 13.6.3.

- A1.2.34
- (1) An Operator or Trustee must maintain records of all Agreements and any instructions given by the Operator or Trustee to the Eligible Custodian under the terms of the Agreement.
 - (2) The records must be maintained for at least six years.