



BERMUDA MONETARY AUTHORITY

DISCUSSION PAPER

Development of a Bermuda AIFM Regime

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I. INTRODUCTION

1. Since early 2014, the Bermuda Monetary Authority (“BMA” or “the Authority”) has been engaging with industry stakeholders with regard to the Alternative Investment Fund Managers (“AIFM”) regime in the EU, and the appropriate actions for Bermuda to take in response. This dialogue concluded that a domestic AIFM regime would assist marketing activities of Bermuda fund managers and funds, both under current EU provisions for Private Placement and transitioning through to a full AIFM regime. Further, there was consensus that the BMA would best achieve such a regime by amending the Investment Business Act 2003 (“IBA” or “the Act”) and developing associated Bermuda AIFM regulations, which would address, in full, the detailed requirements of the EU regime.
2. The points raised in this Paper are intended to instigate discussion with industry on the Authority’s plans to amend existing Bermuda law and develop appropriate regulations in order to create the necessary legal framework.
3. Utilising standalone AIFM regulations made under principal legislation would be consistent with the current legal framework in Bermuda and would provide an approach that would not interfere with those Bermuda fund managers who do not intend to market their products in Europe. The purpose of this Discussion Paper (“DP”) is to invite feedback on this proposed course of action and any wider AIFM related issues.
4. While the BMA has concluded that an amendment to the IBA would be the starting point for developing this regime, numerous points (both from a conceptual perspective and in terms of the detail necessary to create the regime) require resolution before the amendment can be drafted.
5. Section II of this Paper provides background on how the BMA arrived at its current position. Section III provides a description of the existing regime for investment funds and/ or managers in Bermuda and Section IV outlines a summary of the EU AIFM regime. Section V focuses on specific discussion points raised to date in relation to applying the EU regime in Bermuda. In particular, stakeholders are asked to consider the text in italics which outlines the BMA’s current line of thinking and highlights the issues requiring resolution.

6. Stakeholders are kindly requested to provide feedback on the broad implications of implementing the AIFM regime in Bermuda and also on the discussion points and/or policy options in italics throughout this Paper. Please forward submissions to policy@bma.bm by 9th January 2015.

II. BACKGROUND

7. In its 2014 Business Plan the BMA committed to investigating the possibility of introducing an AIFM regulatory and supervisory regime for Bermuda fund managers who choose to come under such a regime. To be effective, the proposal must reflect the EU regime, which itself seeks to establish common requirements governing the authorisation and supervision of fund managers who are domiciled and/or market Alternative Investment Funds (“AIFs”) in the EU.
8. Discussions to date, both internally and with industry stakeholders, indicate general consensus that Bermuda needs to develop an appropriate response to the EU AIFM regime. Dialogue with a sub-group of the Bermuda Business Development Agency (“BDA”) has assisted the BMA in reaching the position outlined in this Paper. The BMA is now seeking views from a wider audience, both on the proposed objective and the means to achieve it.
9. The Framework Directive (“2011/61/EU” or “the Directive”) and subsequent European Commission (“EC”) Delegated and Implementing Regulations (“No 231/2013”; “No 447/2013”; “No 448/2013”) came into force on 22nd July 2013. Article 61(1) of the Directive allowed a ‘transitional’ period of one year, during which time AIFMs were required to comply with relevant requirements on a best efforts basis while their applications for authorisation were being processed.
10. At present, EU Member States are permitted to allow non-EU AIFMs to manage EU AIFs and/or market AIFs to professional investors in their respective territories, subject to national law governing private placement regimes (“NPPRs”). The European Securities and Markets Authority (“ESMA”) has, however, signalled its intention to abolish NPPRs by 2018. ESMA is due to deliver an opinion to the EC by July 2015 on the functioning of the AIFM passport within Europe and how it might be developed in relation to non-EU Member States (“third countries”), such as Bermuda. According to the current timelines, management and/or marketing of AIFs in the EU post 2018 would only be allowed in accordance with the terms of the full EU AIFM regime.

11. While no explicit arrangements are set out for achieving ‘equivalence’ with the European regime, third countries can make preparations to support cross border activity of their domestic industry by signing a Memorandum of Understanding (“MoU”) with EU countries on a bilateral basis. The BMA has been successful in signing MoUs with the majority of Member States in the EU¹ and is supportive of building on this and working in a meaningful way to develop an appropriate AIFM solution for Bermuda in the long term.
12. It is intended that the Bermuda Monetary Authority Act 1969 be amended to address AIFM related fees. The fee(s) to be levied on opt-in managers would need to be commensurate with the cost of supervision and we note that, based on the nature of the EU regime, additional resources will be required for the Authority to effectively supervise this sector. The BMA has not reached a definitive conclusion on this matter and will continue to consider cost implications as details of the framework are being developed.

III. SUMMARY OF BERMUDA REQUIREMENTS

13. At present, the Bermuda fund and fund management regimes are prescribed under the framework of two key Acts: the IBA and the Investment Funds Act 2006 (“IFA”). The IBA outlines the regulatory framework for activity of those conducting investment business, including fund management, via a physical presence in Bermuda. The IFA outlines the regulatory framework for funds set up in Bermuda. Under the IFA, funds must appoint an investment manager, although that investment manager is not required to be physically present in Bermuda.
14. The BMA has identified the IBA as the principal legislation for implementing the Bermuda AIFM regime, because it focuses on the supervision of investment businesses and managers, and thereby:
 - a) Would provide the most legal certainty for a Bermuda AIFM regime;
 - b) Is consistent with the approach taken by the EU when creating its AIFM regime;

¹ <http://www.bma.bm/SitePages/AIFMD.aspx>
<http://www.esma.europa.eu/content/AIFMD-MoUs-signed-EU-authorities-updated>

- c) Is consistent with the approaches of peer jurisdictions that are also working to develop a position in this space.

IV. SUMMARY OF EU AIFM REQUIREMENTS

In general

15. As previously mentioned, the purpose of this Paper is to discuss the points in the EU AIFM regime which Bermuda would need to address. The general approach followed by the BMA is that all EU AIFM requirements would be applicable to those choosing to opt in to a Bermuda AIFM regime. To provide some context, this section summarises the EU AIFM framework, but should not be considered a proposed draft Bermuda AIFM regime. To understand the rationale for the BMA's approach, the EU AIFM framework should be read in its entirety.

Authorisation and activities

16. In addition to general provisions required to be fulfilled under the Act when applying for authorisation, an AIFM must demonstrate compliance with the EU regulatory regime and maintain ongoing compliance. The following are outlined as the main functions which an AIFM would be intending to carry out under the terms of its authorisation:

- a) Investment management functions: portfolio management; risk management.
- b) Other functions: administration (legal and fund management accounting services; customer inquiries; valuation and pricing, including tax returns; regulatory compliance monitoring; maintenance of unit/shareholder register; distribution of income; units/shares issuance and redemption; contract settlements, including certificate dispatch; record keeping) and marketing.
- c) Activities related to the assets of AIFs: services to meet fiduciary duties; facilities management; real estate administration; advice on capital structure; industrial strategy and related matters; advice and services related to mergers.

Initial capital and own funds

17. Upon first time authorisation and on a continuous basis, the AIFM must hold sufficient capital and own funds per the assigned criteria:

- a) An AIFM which is an internally managed AIF must hold initial capital of at least €300,000.
- b) An AIFM which is appointed as an external manager of AIFs must hold initial capital of at least €125,000.
- c) Where the value of portfolios of the AIFs managed by the AIFM exceeds €250 million, 0.02% of the excess value must be held as own funds. This shall not, however, exceed €10 million.
- d) AIFMs must hold additional own funds, or hold professional indemnity insurance, against liability arising from professional negligence.

Organisational requirements

18. AIFMs must observe the following requirements with regard to their organisational structure:

- a) AIFMs shall not outsource the risk management function and the portfolio management functions at the same time.
- b) Subject to supervisory approval, delegation of AIFM activities to third parties would be permissible provided that the AIFM retains responsibility for ultimate oversight of the activities in question and the below requirements are maintained. Additional considerations are to be taken into account when the delegation refers to risk and/or portfolio management:
 - i. The delegation should not lead to circumvention of the rules and/or give rise to conflicts of interest;
 - ii. The delegation should not lead to the AIFM being considered a 'letter-box entity'.

- c) Restrictions on being a letter-box entity, whereby an AIFM would no longer be considered to be the manager of an AIF because:
 - i. It no longer retains the necessary expertise and resources to supervise delegated tasks effectively and manage the risks associated with the delegation;
 - ii. It no longer has the power to take decisions in key areas which fall under the senior management's responsibility or no longer has the power to perform senior management functions, in particular in relation to the implementation of the general investment policy and investment strategies;
 - iii. It loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice;
 - iv. It delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself.

- d) AIFMs must have a risk management function that is functionally and hierarchically separate from operating units, including from the function of portfolio management.

- e) AIFMs are expected to have a permanent compliance and internal audit function.

- f) AIFMs shall establish, implement and maintain record-keeping requirements for, among other things, portfolio transactions and subscription/redemption orders. Records shall be retained for a minimum of five years.

- g) AIFMs shall be able to demonstrate at all times that the portfolio of the AIF is fairly and appropriately valued. The valuation rules applied shall be consistent with the rules of the country where the AIF is established.

Operating conditions

19. AIFMs must observe the following requirements with regard to their operating conditions:

- a) AIFMs must adhere to requirements regarding due diligence, particularly during the selection and ongoing monitoring of assets in which they invest.
- b) AIFMs are required to have a remuneration policy in place for senior management, risk takers, those involved in the control functions or those whose total remuneration puts them into a bracket equivalent to the aforementioned staff.
- c) AIFMs must identify, manage, monitor and prevent conflicts of interest. If appropriate, this may be done via segregation of tasks and responsibilities within the general operating environment.
- d) With regard to conflicts of interest and the use of prime broker services, the AIFM must outline in a written contract, among other points, the transfer and reuse of AIF assets.
- e) The risk management function is expected to play a key role in the AIFM's work on assessing and setting risk, leverage and liquidity limits, in addition to work related to stress testing.
- f) Before assuming exposure to credit risk of a securitisation, AIFMs must receive confirmation from the originator, sponsor or original lender that they have retained a net economic interest in the securitisation of no less than 5%.

Depositories

20. AIFMs shall ensure that a single depository is appointed for each AIF they manage:

- a) The appointed depository shall be compliant with the relevant EU sectoral regulatory frameworks, i.e. Basel II (2006/48/EC)² and MiFID (2004/39/EC)³.
- b) To ensure mitigation of conflicts of interests, the AIFM itself, or a prime broker acting as counterparty to the AIF, shall not act as the depository.

² Repealed by EU Directive 2013/36/EU and EU Regulation No 575/2013

³ Repealed by EU Directive 2014/65/EU on Markets in Financial Instruments and EU Regulation No 600/2014 on Markets in Financial Instruments

- c) In the broad understanding of the rules, the depositary should be located in the country where the AIF is established, however there are additional provisions for when this country may be outside of the EU.
- d) The depositary shall be responsible for a range of activities including monitoring of cash flows and safe keeping of assets.
- e) Article 36 of the AIFM framework directive allows for some flexibility regarding application of depositary rules. This would apply only to EU AIFMs marketing non-EU AIFs to professional investors. In such cases the exact requirements will be laid out in the national regime of the EU Member State at their discretion.

Transparency requirements

21. For each AIF they manage, AIFMs are required to:

- a) Publish an Annual Report for each financial year no later than six months following the end of the financial year.
- b) Ensure that certain disclosure requirements are fulfilled before investors invest in AIFs, and thereafter upon a material change. The rules regarding the frequency of disclosure to investors are largely determined by the rules of incorporation of the AIF.
- c) Set out supervisory reporting on a systematic basis according to quarterly, bi-annual and annual deadlines.

Managing specific types of AIFs

22. Certain requirements to monitor and mitigate potential contributions to systemic risk apply to both AIFMs and supervisory authorities:

- a) Regarding the impact of leverage on the overall financial systems, there is an obligation for supervisory authorities to collect and monitor information received via AIFM reporting to identify the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system, risks of

disorderly markets and risks to the long-term growth of the economy. The supervisory authority is required to share this analysis with ESMA and the European Systemic Risk Board (“ESRB”).

- b) When an AIF acquires a majority holding or control of a non-listed company, the AIFM in question is required to:
 - i. Notify its supervisor, the non-listed company in question and the company’s shareholders;
 - ii. Make available to the aforementioned parties information regarding the identity of all those concerned, the policy for preventing and managing conflicts of interest and the policy for external and internal communication of the transaction.

- c) Requirements are set out with regard to asset stripping, and supervisors will have the power to prevent certain actions of the AIFM in this respect.

Third country relations

23. It is currently envisaged that relations with third country AIFs and AIFMs shall be organised via a European Member State of reference.

- a) There are numerous combinations possible depending on whether:
 - i. The activity relates to management and/or marketing;
 - ii. The target recipient of marketing is a retail or professional investor;
 - iii. The arrangement anticipates passporting;
 - iv. Either the AIFM and/or the AIF are based outside of the EU.

- b) The EC and ESMA have yet to deliver many of the more detailed rules regarding cooperation and interaction between EU Member States and third countries. The approach should become clear on this front by July 2015, when ESMA will deliver its opinion to the EC. While this will primarily cover functioning of the AIFM passport within Europe, it is also expected to reflect on how this might be developed in relation to third countries.

V. DISCUSSION POINTS ON A BERMUDA AIFM OPT-IN REGIME

Legislative foundation for Bermuda AIFM opt-in regime

24. It is proposed that the legislative foundation for the Bermuda AIFM regime be established via an amendment to the IBA and that detailed requirements of the regime be addressed in Bermuda AIFM regulations. To advance Bermuda's position in discussions with ESMA and other EU Supervisory Authorities, the starting point for the regime would be the detailed EU legislative texts on AIFM with focus given to how they will be incorporated into the Bermuda framework. As previously stated, it is unlikely that the substance of the Bermuda framework would deviate substantially from the content outlined in the EU regime.

25. In order to provide a comprehensive legal basis for this regime, the BMA is assessing which provisions under each title of AIFM must be laid out in the Act, possibly in a new and separate part, and which could be drafted in the regulations. While the BMA has not reached a conclusion on the exact basis for making such assignments, the following points are seen as guiding factors:

a) All sections of the AIFM framework should be introduced via the IBA amendment, as this would constitute the enabling power;

b) While remaining proportionate to the rest of the Act, the IBA amendment should be sufficiently detailed to give the reader a clear understanding of the policy direction intended for the Bermuda AIFM regime;

c) Any numerical value which may be subject to change should be directed at the Bermuda AIFM regulations rather than the Act, for example monetary values, reporting dates etc.

26. The BMA continues to analyse the complexity of applying the EU regime to the Bermuda market and areas in which a direct read across would be difficult to implement. The following pieces of legislation are referenced in the EU AIFM texts:

a) 2nd Company Law Directive (77/91/EEC);

b) Investor compensation schemes (97/9/EC);

- c) *Informing and consulting employees (2002/14/EC)*;
- d) *Prospectus Directive (2003/71/EC)*;
- e) *Size of SME (2003/361/EC)*;
- f) *Control of issuers (2004/25/EC)*;
- g) *MiFID (2004/39/EC)*;
- h) *Basel II (2006/48/EC) (2006/49/EC)*;
- i) *UCITS (2009/65/EC)*.

27. According to parliamentary convention, it would be unusual to include direct reference to foreign legislation in Bermuda statutes, and for this reason the policy implications of each of these directives must be clearly understood and addressed in the Bermuda regime.

- a) *In this context, the BMA is considering how to deal with cross referencing within the EU AIFM legislative texts to other EU sectoral regimes.*

Scope

28. The intended purpose of this initiative is to establish a legislative AIFM framework which would provide the regulatory oversight for Bermuda-based investment managers in order to facilitate the management and marketing of their funds in the EU. As such, the BMA intends to make clear in the IBA amendment that this regime would only be applied to those managers who seek to carry on business in the EU. It is anticipated that:

- a) *Bermuda managers could elect to comply with the full AIFM regime and be granted AIFM designation by the Authority;*

- b) Such a designation could appear on a Bermuda manager's IBA licence or be encompassed within its classification, should such a system exist;*
 - c) Existing IBA licensees/managers wishing to ensure they may carry on business in the EU could apply for Bermuda AIFM designation at any time.*
- 29. The BMA continues to discuss the different combinations associated with determining who would be eligible to apply for designation under the Bermuda AIFM regime. The status of the following entities, and any related prerequisite requirements, are being considered in this respect:
 - a) IBA licensees;*
 - b) Entities exempted under the IBA;*
 - c) Managers of funds which currently fall out of scope of the Bermuda regime e.g. closed ended funds.*
- 30. Before granting designation as a Bermuda AIFM, the BMA would validate that the relevant manager complies with the requirements of the full Bermuda AIFM regime, including minimum licensing and authorisation requirements. In order to avoid conflicting regulatory standards, it is expected that for Bermuda AIFMs, the obligations specific to that regime would prevail over general requirements of the IBA. Please note that in this Paper, this is referred to as the “de facto approach”.
- 31. While not explicitly stated as such, the EU regime is drafted in such a way as to differentiate between institutional and retail investors. The BMA continues to discuss:
 - a) If such a differentiation would be required in the Bermuda regime, and how this would be referenced to the current classification structure for authorised funds;*
 - b) If developing the Bermuda regime on an opt-in basis would be sufficient to establish the scope of application.*
- 32. The BMA continues to discuss crossover issues raised in the IBA and in the EU AIFM framework. While the de facto approach is that AIFM requirements would supersede

those of the wider IBA if there is any conflict, care must be taken to ensure a certain level of consistency is maintained. An example of this arises when looking at the definition of “Investment Activities” in the IBA. While Part 2 of the First Schedule of the IBA provides detailed examples of “Investment Activities”, these do not correspond directly to the broad categories defined in the EU AIFM regime (outlined in paragraph 15 of this paper). We note that in the EU regime, the equivalent to IBA “activities” are referred to as “functions the AIFM must perform”. As such, the BMA is considering:

- a) Whether the language within Part 2 of the First Schedule of the IBA is broad enough to support the functions/activities of Bermuda AIFMs;*
- b) To what extent there should be consistency between the Schedules of the IBA and the Bermuda AIFM Regime, or if they can remain as two standalone sections;*
- c) If Part 2 of the First Schedule should be amended to lay the foundation for the Bermuda AIFM regulations.*

33. Closed-ended funds are not currently recognised as investment funds in Bermuda law, but they do fall within the scope of the EU AIFM regime. Accordingly, the Authority is analysing how/where such vehicles should be incorporated into the domestic legislative framework. The BMA is also assessing its current obligations under the MoUs which has led to consideration of the following options:

- a) Define management of closed-ended funds in the Bermuda AIFM regulations: this would be consistent with the de facto approach, however there may be cases, between now and implementation of a Bermuda AIFM regime, whereby Bermuda Managers encounter challenges when seeking to market closed-ended funds in the EU.*
- b) Define management of closed-ended funds in the IBA: this would provide more certainty for closed-ended funds until they can be considered in the context of the Bermuda AIFM regime, however there are implications associated with this approach in terms of affecting the scope of the current IBA.*

34. The BMA is looking further into the definition of “control” outlined in the EU AIFM Framework Directive (Article 26) and the definition of “controller” outlined in the IBA (section 7(5)). There appears to be a disparity in the thresholds for control specified within the respective frameworks and the BMA is considering how this would be resolved in the context of the Bermuda AIFM framework. The extracts under consideration are as follows:

a) Article 26 of the EU AIFM Framework Directive states that “control shall mean more than 50% of the voting rights of the companies...”.

b) S7(5) of the IBA differentiates between a “ten per cent shareholder controller” and a “majority shareholder controller”, with the definition for the latter stating that a “majority shareholder controller means a shareholder controller in whose case the percentage referred to in the relevant paragraph is fifty or more”.

Application for authorisation

35. Given that the Authority must be satisfied that there will be compliance with the full AIFM regime at the time of the licensing application and ongoing, the BMA considers that a sufficient level of detail on these requirements should be outlined in the IBA amendment. The BMA is considering the challenges around how these would be made directly applicable to Bermuda AIFMs as opposed to IBA licensees and exempted entities. In this context, the BMA seeks feedback on:

a) Whether a specific licence, classification or designation should be applied to Bermuda AIFMs.

Initial capital and own funds

36. Since this section contains monetary values which may be subject to change, the BMA foresees the general provision for initial capital and own funds being outlined in the IBA, with the exact thresholds being detailed in the Bermuda AIFM regulations.

37. The EU regime cites the Euro as the applicable currency. As references to currency can only be made in Bermuda dollar values, the BMA anticipates:

a) *Significant changes in the EU regime will have to be monitored closely to facilitate the maintenance of appropriate equivalent amounts in local currency.*

38. As a general principle, the BMA believes that to account for inevitable currency fluctuations, Bermuda AIFMs would monitor and maintain a level of own funds in excess of the minimum requirements.

Organisational requirements

39. The BMA is considering issues arising from rules in the EU AIFM framework regarding delegation to third parties, conditions under which an AIFM may be rendered a letter-box entity (please refer to paragraph 18(c)) and how the BMA could ensure that ultimate oversight at the level of the Bermuda AIFM is maintained. In this context, the following points are under discussion:

a) *How to articulate in the Bermuda regime that Bermuda AIFMs cannot delegate both the risk management and portfolio management functions.*

b) *How the BMA should assess whether the licensee delegates more than it retains.*

c) *What would constitute physical presence in the Bermuda context.*

d) *To what degree 'licensing' and 'activity' should be performed in the same jurisdiction.*

Depositaries

40. The BMA is in the process of considering market participants who are presently active in this area and/or may develop their mandate in this space in the future. There are two target audiences in this respect:

a) *Niche funds holding other assets which are not easily traded, e.g. real estate deeds, insurance contracts, art.*

Given the current state of play in Bermuda and the limitations/conditions⁴ surrounding the ability of certain entities to hold client assets, the BMA is keen to discuss with stakeholders:

- i. The current and evolving role of fund administrators in the custodian space;*
- ii. How to deal with 'physical' assets which are not readily traded on financial markets.*

b) Mainstream funds, e.g. those that are trading in portfolios of securities

The BMA is considering the wider depositary rules laid out in the EU AIFM regime and hoping to discuss more generally with stakeholders:

- i. The current position of Bermuda banks with regard to custodian and depositary activity;*
- ii. The possible need to require Bermuda AIFMs to appoint an EU depositary.*

Transparency requirements

41. The EU AIFM regime requires that additional reporting and disclosure requirements be initiated upon occurrence of a material change. While this does not conflict with current requirements under the IBA or IFA, the scope in those Acts applies only to Bermuda funds. The BMA continues to discuss the following points:

- a) Reporting the occurrence of material change beyond Bermuda domiciled funds would constitute an extension of scope to the current regime. The BMA is considering how best to address the legislative scope in terms of the Bermuda AIFM regime.*
- b) The approach to be taken by the BMA on receiving notifications of material change on AIFs located in other jurisdictions and how that would be managed by the Authority.*

⁴ Certain fund administrators are prohibited from holding client assets by section 43(3) of the IFA. Also, fund managers must indicate when submitting a 'form of application for an investment business licence' (Investment Business Regulations 2004, part 1 of the schedule) that they wish to provide a service of 'safeguarding and administering investments'. They may only offer this service if the BMA expressly grants them permission to do so.

42. The EU AIFM reporting regime outlines thresholds based on Assets under Management (“AUM”). In this context, the BMA is considering:

a) Whether AUM would include values from Non-EU AIFs and, if they had to be split, how this would be done.

VI. CONCLUSIONS

43. While advancing this AIFM initiative, the Authority is mindful of international regulatory developments relating to investment management and investment business generally, and continues to assess the broader Bermuda regime in order to maintain adherence to international principles and standards in these areas.

44. While the work on AIFM is in response to direct calls from the domestic industry, it goes some way towards fulfilling obligations at the international level and maintaining Bermuda’s position as a competitive and credible jurisdiction in this space.

45. The Authority welcomes views on these discussion points, as well as any other related issues which the reader may deem appropriate, in the context of developing a Bermuda AIFM opt-in regime.