

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 as defined in Article 7(a) 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 as defined in Article 7(a) 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

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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. Repurchase agreements: The repurchase 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 repurchase 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 those defined in Article 7 point (a) 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.

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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.

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Changes and effects yet to be applied to :

- Regulation revoked by [2023 c. 29 Sch. 1 Pt. 3](#)

Changes and effects yet to be applied to the whole legislation item and associated provisions

- Art. 50(a) words substituted by [S.I. 2024/705 Sch. 2 para. 15\(a\)](#)
- Art. 50(b) words substituted by [S.I. 2024/705 Sch. 2 para. 15\(b\)](#)
- Art. 50(c) words substituted by [S.I. 2024/705 Sch. 2 para. 15\(c\)](#)
- Art. 50(d) words substituted by [S.I. 2024/705 Sch. 2 para. 15\(d\)](#)
- Art. 50(e) omitted by [S.I. 2024/705 Sch. 2 para. 15\(e\)](#)