

DP12/1

Financial Services Authority

Implementation of the Alternative Investment Fund Managers Directive

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The Financial Services Authority invites comments on this Discussion Paper. Comments should reach us by 23 March 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/DP/2012/dp12_01_response.shtml.

Alternatively, please send comments in writing to:

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A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Discussion Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

This communication is not general guidance under the Financial Services and Markets Act 2000 but reflects our current thinking on the Directive and the types of issues that affected firms should begin to consider. It does not contain any policy proposals, nor does it amend or qualify any existing rules or guidance in the FSA's Handbook. It is intended solely as a preliminary document and does not prejudice any further consultation undertaken by the Treasury, the FSA or the FSA's successor organisations.

Significant aspects of the framework which will support the Directive are subject to further negotiation and adoption by the European Commission. Subordinate measures relating to a number of key areas in the Directive are in the early stages of development at EU level. ESMA guidelines will also be issued in some areas covered by the Directive.

Accordingly, the content of this communication is subject to such future measures to be adopted. This communication will also be superseded by any rules and guidance that the FSA or any successor body makes in the future to transpose AIFMD, on which we will consult in due course.

Abbreviations used in this paper

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Directive 2011/61/EU on Alternative Investment Fund Managers
APER	Statements of Principle and Code of Practice for Approved Persons sourcebook of the FSA Handbook
AUM	Assets under management
BIPRU	The Prudential sourcebook for Banks, Building Societies and Investment Firms of the FSA Handbook
CAD	Directive 2006/49/EC on capital adequacy of investment firms and credit institutions
CIS	Collective Investment Scheme
CESR	Committee of European Securities Regulators
COBS	Conduct of Business sourcebook of the FSA Handbook
COLL	Collective Investment Schemes sourcebook of the FSA Handbook
Commission	European Commission
CPIF	Charity Pooled Investment Funds
DP	Discussion Paper
EEA	European Economic Area
ESA	European Supervisory Authority
ESFS	European System of Financial Supervision

ESMA	European Securities and Markets Authority
ESMA advice	Final Report on ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive published on 16 November 2011
ESRB	European Systemic Risk Board
EU	European Union which includes the European Economic Area (EEA) unless otherwise stated
FAIF	Fund of Alternative Investment Funds
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
FSMA	Financial Services and Markets Act 2000 (as amended)
G20	The Group of Twenty Finance Ministers and Central Bank Governors
GENPRU	The General Prudential sourcebook of the FSA Handbook
IPRU (INV)	The Interim Prudential sourcebook for Investment Businesses of the FSA Handbook
JV	Joint Venture
Member State	A Member State of the European Union
MiFID	Directive 2004/39/EC on Markets in Financial Instruments
NAV	Net Asset Value
NPP	National Private Placement
NURS	Non-UCITS Retail Schemes
OEIC	Open-ended Investment Company established under the OEIC Regulations
OEIC Regulations	Open-Ended Investment Company Regulations 2001 (SI 2001/1228) (as amended)
OJ	Official Journal of the European Union
PII	Professional Indemnity Insurance
PRA	Prudential Regulatory Authority

Prospectus Directive	Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading (as amended)
QIS	Qualified Investor Schemes
RAO	Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (as amended)
REIT	Real Estate Investment Trusts
Solvency II	Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance
SPE	Special Purpose Entity
SUP	The Supervision sourcebook of the FSA Handbook
SYSC	Senior Management Arrangements, Systems and Controls sourcebook of the FSA Handbook
The Treasury	Her Majesty's Treasury
UCIS	Unregulated Collective Investment Scheme
UCITS	Undertakings for Collective Investment in Transferable Securities
UCITS Directive	Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertaking for collective investment in transferable securities (recast)
UK Authorities	The FSA and the Treasury
UPRU	The Prudential sourcebook for UCITS Firms of the FSA Handbook

1

Overview

Introduction

1.1 We have prepared this Discussion paper (DP) to set out some provisional thinking in our approach to implementing the Alternative Investment Fund Managers Directive (the Directive or AIFMD) in the UK. This DP is the first step in the process of implementing the Directive. There is a great deal to be done for implementation in what is a tight and aggressive timeline. Early communication and timely consultation and planning by regulators and industry alike, are crucial for effective and proportionate implementation. To that end, this DP is intended to be a constructive tool for preliminary engagement to highlight material areas for policy development, and identify challenges and potential changes for affected stakeholders.

Objectives of the DP

1.2 The DP's objectives are twofold:

i) Development of well-informed, proportionate and effective regulatory policy

The Directive raises questions about material structural change for industry. We wish to explore the opportunity with stakeholders – within applicable EU and domestic parameters – to adjust regulation in the collective fund management space and develop effective policies for the transposition of the Directive.

1.3 As the Directive is principally maximum harmonising¹, there are limitations on what additional regulatory requirements we may impose on alternative investment fund managers (AIFMs). It also means any existing FSA rules conflicting with the Directive may no longer be maintained. The Directive also represents an opportunity for regulatory 'streamlining' in the sense that this may be an opportunity to amend our domestic fund management rules to be more consistent with the Directive.² We expect proposed policy positions and any rules amendments to be published in an FSA Consultation Paper later

¹ A maximum harmonising Directive leaves minimum room for Member States to enact their own national rules in a given area.
² See Section 9 'Categories of AIF and specialised regimes'.

this year. Stakeholders will again be invited to comment.

- 1.4 Against this backdrop, the coalition government's regulatory reform programme will revise our regulatory objectives. The FSA will itself be succeeded by a new Financial Conduct Authority (FCA), the likely UK regulator for fund management and markets from 2013.

ii) Assisting stakeholders towards 'AIFMD-readiness'

- 1.5 This Directive raises questions of material change for UK businesses operating in the collective fund management space – signalling significant changes from July 2013, not only for fund managers but also for depositaries, valuers and administrators.

- 1.6 Implementation will significantly alter the regulatory framework under which (potential) AIFMs currently operate, manage and/or market alternative investment funds (AIFs) in the UK and across the EU. It will change how AIFMs operate their businesses, how they interact with third-party service providers under delegation (outsourcing) and depositary arrangements, administration and external valuers. It means a new set of requirements for listed internally managed AIFs currently subject to the listing rules of the UK Listing Authority. Implementing the Directive will also affect relations with investors, shareholders of corporate AIFs and national and EU regulatory authorities.

- 1.7 The Directive seeks to regulate the management of a diverse range of funds – hedge funds, private equity, property, listed funds, funds of funds, and commodity funds. Most FSA-regulated firms that manage and/or market investment funds³ that are not authorised under the UCITS Directive are likely to be affected. The extent to which the Directive will affect an individual AIFM will depend on a number of factors. These include:

- where the AIFM and the AIF are established;
- the nature of the AIF;
- the AIFM's marketing presence, if any, within one or more Member States;
- whether an AIFM intends to use the Directive's managing and/or marketing passports;
- an AIFM's commercial and operational structures; and
- the location of AIF depositaries.

- 1.8 Preparation for the Directive's implementation will intensify over the next 18 months. Senior management of stakeholders, particularly potential AIFMs, should engage with the issues in this paper. They should anticipate and consider their response to the upcoming operational challenges towards a state of 'AIFMD-readiness'. They should also begin earmarking sufficient and appropriately qualified resources to identify likely impacts of the Directive on their business models.

³ The term 'investment funds' is used hereafter to refer to collective investment undertakings or schemes.

- 1.9 Stakeholders should not overlook that new business opportunities will emerge in the collective fund management sector by virtue of the Directive's significant deregulatory effect on Member State national rules or barriers. On the basis of a single Member State authorisation, AIFMs will from 22 July 2013 be able to access an EU-wide professional investor base by taking commercial advantage of the new AIF management and/or marketing passport. In some Member States, AIFMs will also have access to retail investors under certain conditions.⁴ These opportunities have the potential to lower costs and remove barriers to entry, engendering competition. Any 'AIFMD-ready' AIFMs will be well-positioned to benefit from these regulatory and market changes.
- 1.10 With these objectives in mind, the DP contains a number of important and, we hope, useful questions on which we invite comment by stakeholders. The heterogeneity of the sector to be brought into AIFMD regulation and the timeline within which transposition needs to be achieved poses a considerable challenge for all of us. We hope that responses from stakeholders will help us to continue on the path already embarked upon: one of engaged, constructive and expert dialogue towards achieving effective and proportionate outcomes for the collective fund management industry in the UK.

What is the AIFMD?

- 1.11 The Directive⁵ was published in the *Official Journal of the European Union*⁶ on 1 July 2011. EU Member States, such as the UK, are required to transpose the Directive by 22 July 2013. The Directive is one of several pieces of EU and domestic regulation that firms, especially fund managers, will need to consider over the next 18 months.
- 1.12 The Directive forms part of a legislative programme put forward by the Commission to '*extend appropriate regulation and oversight to all actors and activities that embed significant risks*'.⁷
- 1.13 The goals for the Directive were to:
- establish a secure, harmonised EU framework for monitoring and supervising the risks that AIFMs pose to their investors, counterparties and other financial market participants and to financial stability; and
 - permit, subject to compliance with strict requirements, AIFMs to provide services and market their funds across the internal market.⁸

4 For discussion of the conditions under which EU AIFs may be marketed to retail investors please refer to Section 8.

5 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 EU (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>)

6 The Official Journal of the European Union is a gazette of, *inter alia*, legally binding acts agreed by the Council of Ministers of the European Union and the European Parliament (available from <http://eur-lex.europa.eu/JOIndex.do?ihmlang=en>).

7 Commission Communication for the Spring European Council, March 2009. (summary available from <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/351&format=HTML&aged=0&language=EN&guiLanguage=en>).

8 Commission Proposal for a Directive on Alternative Investment Fund Managers, 30 April 2009, (available from http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf).

What firms are potentially UK AIFMs?

- 1.14** At this stage the likely population of UK AIFMs⁹ is undetermined. The FCA's approach document estimated that over 2,100 investment managers and over 550 collective investment schemes (CIS) may be within the scope of the FCA's regulatory perimeter.¹⁰ Based on various internal and industry estimates, we consider that over 1,000 firms and schemes are likely to be within the scope of the Directive.
- 1.15** Whether a UK entity will be an AIFM will be contingent on several factors, including:
- the value of assets under management (AUM) of the portfolios of AIF under management;
 - the nature of the investment strategy;
 - internal organisation, legal and operational structure;
 - legal and contractual arrangements between the AIFM and the AIF under management, and those between the AIFM and third-party service providers, including to what extent it has delegated the activity of portfolio and risk management;
 - location and/or domicile of the potential AIFMs and that of the AIFs under management;
 - the extent and location of any marketing activities in the UK and in the EU.¹¹
- 1.16** We expect the AIF population to be diverse, which in turn would mean that there will be a diverse population of AIFMs. As an illustrative starting point, we expect that some, or all, of the following, may be considered UK AIFs:
- hedge funds, hedge funds of funds;
 - private equity and venture capital funds;
 - property funds;
 - investment trusts;
 - Real Estate Investment Trusts (REITs);
 - FSA-authorised non-UCITS funds including Non-UCITS Retail Schemes (NURS), Funds of Alternative Investment Funds (FAIFs) and Qualified Investor Schemes (QIS);
 - charity funds (these are distinct from social funds which are currently the subject of a Commission proposal for regulation);
 - commodity funds; and
 - infrastructure funds.

⁹ Unless otherwise stated the term 'AIFM' is used hereafter in this paper to refer to an AIFM established in the UK and authorised by the FSA.

¹⁰ Table 1, The Financial Conduct Authority Approach to Regulation (June 2011): www.fsa.gov.uk/pubs/events/fca_approach.pdf (referred to hereafter as 'the FCA Approach Document')

¹¹ Marketing by AIFM in the EU includes the three EEA States of Norway, Iceland and Liechtenstein.

- 1.17 Our engagement with stakeholders to date suggests that the application of the Directive to the full range of operating and legal structures in the AIF sector requires further consideration. The Directive perimeter will need to be drawn with a number of these key issues in mind.
- 1.18 After the launch of this DP we intend to undertake a preliminary firm categorisation exercise to determine more clearly the likely population of UK AIFMs coming within scope of the Directive. It will be similar to the exercise that was undertaken by the FSA in preparation for MiFID in 2005, but will also ask for information about potential compliance costs relating to various policy options.
- 1.19 A more detailed discussion of the Directive's scope is in Section 3.

What is the likely impact for AIFMs?

- 1.20 Certainty on the precise application of the Directive to UK AIFMs still depends to a significant extent on the outcome of elements of the subordinate measures¹² which will expand on the Directive. For example, the Commission has yet to set out its proposals for subordinate measures based on ESMA's advice. ESMA must develop draft regulatory technical standards, by way of regulations, concerning types of AIFMs, which the Commission must decide whether or not to endorse.¹³ (See also Section 2.)
- 1.21 The impact on a UK AIFM will depend on a number of factors, including:
- the nature of its operations, including any marketing presence in the EU;
 - the domicile of the AIF(s) under its management;
 - the total AUM of the AIF(s) under management;
 - whether it or the AIF(s) may benefit from one of the article 3 exemptions (see discussion in Section 3); and
 - the fact that the principle of proportionality applies in the implementation of the Directive, for example, in areas such as risk management and remuneration, allowing differentiated application according to the size of AIFM or type of AIF.
- 1.22 The Directive:
- requires AIFMs whose regular business is managing AIFs to be authorised or registered by the FSA (or its appropriate successor); and

12 We use the term 'subordinate measures' in this publication to refer collectively to those legislative measures which may or shall be adopted by the European Commission to specify further the framework under which the Directive will operate. These measures have historically been known as 'Level 2 Measures' but since the introduction of the Treaty of Lisbon now include delegated acts, implementing acts, implementing technical standards and regulatory technical standards.

13 Article 10(1) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, respectively (referred to hereafter as the 'ESMA Regulation').

- does not directly regulate AIFs, but certain requirements may influence an AIF's operation (e.g. requirements on leverage levels and liquidity management).

1.23 In addition to placing obligations on AIFMs, a number of other services and activities¹⁴ are directly or indirectly subject to the Directive's requirements, some of which may be carried out by third-party service providers. These include:

- asset custody;
- prime brokerage facilities;
- fund administration – e.g. legal and fund management accounting service;
- customer inquiries;
- transfer agency;
- valuation and pricing, including tax returns;
- audit;
- outsourcing services;
- portfolio management;
- risk management;
- marketing and distribution; and
- record-keeping.

The structure of this DP

1.24 The structure of this DP is as follows:

- Section 2: provides an overview of key elements and the direction of implementation in the EU and the UK. It covers the implications of UK regulatory reform for AIFMs;
- Section 3: considers questions of scope, covering the definition of an AIF and the treatment of small AIFMs;
- Section 4: outlines the operating requirements on AIFMs including general principles, organisational requirements, risk management, delegation and prudential requirements;
- Section 5: outlines the management requirements on AIFMs, including valuation, liquidity management, use of leverage and securitisation;
- Section 6: outlines the main transparency requirements such as annual reporting, disclosure to investors and reporting to the FSA;

14 Annex I of the Directive.

- Section 7: outlines the requirements on depositaries including duties such as the safekeeping of assets, oversight of administrative functions and the standard of liability;
- Section 8: outlines requirements for marketing including passporting notifications, private placement, marketing to retail investors and public offers of listed AIFs; and
- Section 9: sets out categories of AIF and specialist regimes that apply to certain AIFs such as listed AIFs.

Who should read this DP?

1.25 The Directive will regulate:

- UK-based fund managers that deem at least part of their regular business as managing AIFs (referred to hereafter as ‘UK AIFMs’);
- some discretionary investment managers and operators of collective investment schemes (CIS);
- other firms, such as UCITS management companies, may also be within scope to the extent that they are managing AIFs in addition to managing UCITS; and
- depositaries and custodians holding the assets of AIFs.

DP responses

1.26 The DP process will run for a two-month period from 23 January to 23 March 2012. Responses to this DP should be submitted by 23 March at the latest.

CONSUMERS

The Directive will result in changes to the way in which alternative investment funds are managed and marketed to retail consumers, including non-UCITS Retail Schemes (NURS). These changes are discussed in Section 9.

2

Implementation

This section provides some EU context and background for the Directive, and an overview of key issues arising for its implementation in the UK.

- 2.1 AIFs, particularly hedge funds and private equity funds, began receiving the attention of the Commission in 2006¹⁵ and the European Parliament in 2008.¹⁶ It was the 2008 to 2009 global financial crisis¹⁷, however, that gave renewed impetus to the EU's intentions to shine the regulatory spotlight on the management of AIFs.
- 2.2 The view emerged among regulators, including at the G20 London Summit in April 2009¹⁸, that some activities in the AIF industry embedded significant risk and that the abrupt unwinding of large leveraged positions in response to tightening credit conditions had, with increased investor redemptions, to some extent impaired market liquidity and affected the financial system more generally.
- 2.3 The Directive is based on the premise that certain activities of AIFMs have the potential to amplify risks through the EU financial system. Its main regulatory objectives – investor protection and financial stability in the internal market through regulation of AIF managers – should therefore be viewed against the backdrop of the financial crisis and the consequent regulatory reform initiated at EU level after publication of the *De Larosière* report in February 2009.¹⁹
- 2.4 While the Directive may be described as focusing on the 'alternative' investment sector of hedge and private equity funds, its impact will in practice be far wider. Potentially all funds that are not UCITS, including real estate funds, commodity funds, infrastructure funds,

15 2006 Commission Expert Group on Alternative Investment Funds
(available from http://ec.europa.eu/internal_market/investment/asset_management_en.htm#reports)

16 European Parliament report on hedge funds and private equity: the Rasmussen Report
(available from www.europarl.europa.eu/meetdocs/2004_2009/documents/pr/718/718451/718451en.pdf)

17 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0207:FIN:EN:PDF>

18 The G20 Declaration issued 2 April 2009 'Strengthening the Financial System' stated that the G20 leaders agreed 'to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include, for the first time, systemically important hedge funds; ...' (available from <http://www.g20.org/documents/final-communicue.pdf>)

19 'High-Level Group on Supervision in the EU, chaired by Jacques De Larosière, Brussels, 25 February 2009':
http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

single asset funds, listed and non-listed investment companies, funds of funds and long-only funds structured as anything other than a UCITS, will come within its scope.

- 2.5** For firms marketing to professional investors, the Directive is principally maximum harmonising in effect, save for a handful of permissible Member State derogations or discretions to implement certain provisions on a differentiated basis.²⁰ The Directive should be viewed as the first attempt to create a comprehensive framework for direct regulation and supervision of the AIF management industry. The new rules will affect not only the managers of AIFs, but also depositaries, providers of external valuation and fund administration activities, and investee companies. While the Directive aims to regulate managers of AIFs rather than the AIFs themselves, funds are themselves in a number of ways drawn indirectly into regulation, for example, by virtue of the Directive's liquidity management provisions²¹ and those in relation to leverage calculation.²²
- 2.6** By 2017 the Commission is required to review the Directive's application, scope and regulatory objectives to assess whether it is functioning effectively under internal market doctrine and delivering a level playing-field.²³

Implementation at EU level

- 2.7** The Directive is one of several pieces of important EU regulation to be transposed by Member States following the introduction of the macro-supervisory framework of the EU System for Financial Supervision (ESFS) in January 2011. The ESFS includes the establishment of three new European Supervisory Authorities (ESAs) to oversee macro-supervision of the EU financial services market, coordinating with the European Systemic Risk Board (ESRB) in conjunction with national competent authorities. ESAs are furnished with comprehensive powers. Their tasks include the provision of technical advice to the Commission on implementing measures²⁴, the development of binding technical standards²⁵ (for adoption by the Commission) and the promotion of supervisory convergence in their specific areas of responsibility for the internal market in financial services.
- 2.8** ESMA assumed the responsibilities of what was formerly CESR, having macro-supervisory responsibility for the securities and markets sector with significant new EU-wide supervisory powers.²⁶ These powers, granted under the ESMA Regulation and sectoral legislation such as the Directive, include powers to investigate the breach of EU law²⁷ and

20 Article 60 (Disclosure of derogations). For example, under article 43 retail marketing provisions Member States may allow AIFMs to market to retail investors in their territory and may impose additional regulatory requirements for this purpose (see Section 8).

21 Article 16.

22 Article 4(3).

23 Recital (5) and article 69.

24 Implementing measures are a form of subordinate EU legislation specified in the Level 1 Directive and adopted by the Commission.

25 The term 'binding technical standards' includes regulatory technical standards and implementing technical standards, under articles 10 and 15 ESMA regulation.

26 Article 1(2) ESMA Regulation and by virtue of powers in sectoral directives such as AIFMD.

27 Article 17 ESMA Regulation.

take emergency procedures against national regulators²⁸, issue guidelines and recommendations for its sector²⁹, conduct peer reviews³⁰ and binding mediation in supervisory disputes between EU competent authorities.³¹

2.9 The Directive is the first required to be fully implemented under the ESFS. It contains extensive provisions for EU legislation on implementing measures.³² EU regulators have been working and must continue to work, with ESMA and the Commission to a tight and aggressive timetable in the run-up to the 22 July 2013 transposition deadline.

AIFMD implementing measures

2.10 In December 2010, the Commission issued a mandate to CESR for technical advice on the implementing measures under the Directive. Following extensive deliberations and an EU-wide consultation ending on 13 September 2011, ESMA provided its final technical advice to the Commission on 16 November 2011. This covers a number of key technical areas, such as:

- methodologies for the calculation of use of leverage by AIFMs, risk and liquidity management;
- depositaries (various elements, including cash-monitoring and treatment of collateral);
- valuation of AIF assets; and
- AIFMs operating conditions such as conflicts of interest and organisational requirements.

2.11 The Commission is likely to propose implementing measures for adoption in Q1 2012. It is anticipated that these measures will be adopted using the EU's legislative procedures for delegated and implementing acts³³ by mid-2012.

2.12 We expect that some measures may be enacted as regulations that are directly applicable in Member States. This would be consistent with the EU's desire to promote greater harmonisation and a common supervisory culture among ESAs and national competent authorities. Insofar as any subordinate measures take the form of directives, these may need to be transposed by Member States by the July 2013 deadline.³⁴

28 See for instance articles 8(1)(b) and 9 (5) ESMA Regulation.

29 Article 16 ESMA Regulation.

30 Article 30 ESMA Regulation.

31 Article 19 ESMA Regulation.

32 There are approximately 59 provisions in the Directive for subordinate legislation.

33 Article 290 (delegated acts) and article 291 (implementing acts) Treaty on the Functioning of the EU: Consolidated version of the Treaty on the Functioning of the EU, 13 December 2007, 2008/C 115/01 (available from www.unhcr.org/refworld/docid/4b17a07e2.html)

34 Note that other significant aspects of the framework such as implementing measures on the so-called non-EU passport are subject to further negotiation and adoption by the European Commission. Refer to the discussion in Section 6 below in relation to article 13(2) and Annex II and disclosure obligations on AIFM.

- 2.13 ESMA's 2012 work programme includes developing technical guidelines in areas such as remuneration policies.³⁵ These will expand on obligations on AIFMs to maintain remuneration policies for those staff whose activities could have a material impact on the risk profiles of the AIFM or AIF they manage.³⁶ ESMA guidelines will also be issued in relation to methods to be used by AIFMs to calculate leverage where leverage is used to increase the exposure of AIFs under management.

Implementation in the UK

- 2.14 The UK has for some time maintained supervisory oversight of aspects of the AIF industry through regulation of operators of CIS, principally via the regulated activity of establishing, operating or winding-up a (un)regulated CIS.³⁷
- 2.15 The Directive, however, goes considerably further in that it regulates the structuring, management, operation and marketing of AIFs in the EU. Among its requirements are those relating to risk and liquidity management, transparency and prescribed levels of regulatory capital. There are new rules on investment in securitisations and more detailed rules on the valuation of AIF assets, irrespective of whether this is performed in-house by AIFMs or by external valuers.
- 2.16 A feature of the Directive is that for the first time it requires competent authorities to monitor the potential build-up of systemic risk in the financial system, which may arise from the use of leverage by AIFMs in relation to AIFs under management. This introduces an EU financial stability dimension to fund management regulation: Member States must ensure that their competent authorities possess the necessary powers to supervise the use of leverage and impose supervisory restrictions on AIFMs where necessary to limit the extent to which use of leverage by AIFMs contributes to the build-up of systemic risk in the financial system. This process is coordinated with ESMA, the ESRB and other EU regulators where relevant.³⁸ A number of issues arise from the interaction between the current structure for the regulation of CIS under FSMA and the Directive's requirements. The principal activity to be regulated via national transposition is 'managing AIFs', as defined in the Directive.³⁹ We are considering with the Treasury whether a new 'regulated activity' should be created, with any appropriate amendments to be made to the Regulated Activities Order. It is likely that full Part IV FSMA authorisation will be required for the 'managing AIFs' activity for AIFMs subject to the Directive's full requirements.
- 2.17 The Directive also raises the material question of how the definition of 'AIF' should be transposed into domestic law and the potential effect this may have on the current definition of CIS in s.235 of FSMA. Stakeholders will be invited to comment on this aspect

35 Article 13(2).

36 For example, senior management, risk takers and control functions.

37 Article 51 of the RAO.

38 Article 25(3)-25(8).

39 Article 4(1)(w).

of UK implementation in the UK Authorities' consultation. An opportunity to make submissions on proposed policy positions and/or legal changes to the domestic CIS regime will be available in the FSA and/or Treasury consultations in the second half of 2012.⁴⁰

- 2.18** We envisage that the majority of the Directive's provisions, particularly those directly applicable to AIFMs, will be implemented via rules in the FSA Handbook.
- 2.19** Some Directive provisions will be implemented via regulations to be made by the Treasury under section 2(2) European Communities Act 1972. These will be used to amend primary legislation, such as FSMA, as well as statutory instruments (e.g. the FSMA (Collective Investment Schemes) Order⁴¹). Section 2(2) ECA regulations will also be used to supplement the FSA's (FCA's) powers as regulator of AIFMs. We expect that Treasury regulations will also be used for amendments to give effect to the Directive's scope provisions (e.g. the article 3 exemption provisions).

Implementation implications for the FSA Handbook

- 2.20** Provisions suitable to be transposed via FSA rules are likely to include those relating to conflicts of interest⁴², risk and liquidity management⁴³, and transparency.⁴⁴ Many of these provisions will be shaped finally by the Commission implementing measures, some of which may be adopted as directly applicable regulations. Some of these measures may be reproduced in the Handbook as has been done recently with other Directives (e.g. UCITS Directive), or by referencing the relevant EU regulation as proposed for Solvency II transposition.
- 2.21** Implementation will require revision of a significant number of sections of the FSA Handbook. The Directive does, however, present an opportunity to streamline the Handbook's fund management rules. These rules have to date been maintained principally in COLL. Given the need to implement the Directive and the likelihood of further Directive requirements such as those to be proposed under UCITS V⁴⁵, we are considering a more strategic approach, with the creation of a new sourcebook, provisionally referred to as 'FUND', for fund management rules generally.
- 2.22** Under this approach, COLL would be replaced by 'FUND', containing requirements for both UCITS and AIFMs. The Directive rules fitting conceptually outside of COLL/FUND would, as far as practicable, be included in non-fund sourcebooks (e.g. rules for systems and controls in SYSC and rules for conduct of business in COBS). Our view is that replacing COLL with FUND would allow the sourcebook to be restructured to reflect the new regulatory landscape

40 Consultation dates are preliminary at this date and will be confirmed in due course.

41 Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (SI 2001/1062).

42 Article 14.

43 Articles 15 and 16.

44 Articles 22-24.

45 The Commission has undertaken a public consultation exercise on aspects of the revision to the UCITS framework (commonly known as UCITS V) (http://ec.europa.eu/internal_market/investment/depositary_en.htm)

based on AIFMD, UCITS V, and any EU legislation adopted in due course in relation to venture capital and social entrepreneurship funds.⁴⁶

- 2.23 Questions relating to proposed Handbook changes for our fund management rules will be posed in the 2012 AIFMD Consultation Paper.

Implementation and UK regulatory reform

- 2.24 A significant domestic initiative to be factored into the transposition of the Directive is the coalition government's regulatory reform programme. It has been proposed that the FSA is to be replaced by two separate and distinct prudential and conduct regulators via a 'twin peaks' model of regulation by mid-2013. This will comprise the Prudential Regulatory Authority (PRA) for the prudential regulation of deposit takers, insurers and other systemic firms, and the FCA for conduct regulation of all firms and prudential regulation of all non-PRA regulated firms.
- 2.25 It has been proposed that the FCA will have the single strategic objective of protecting and enhancing confidence in the UK financial system, with three operational objectives:
- i) securing an appropriate degree of protection for consumers;
 - ii) protecting and enhancing the integrity of the UK financial system; and
 - iii) promoting efficiency and choice in the market for financial services.
- 2.26 The working assumption to date is that the FCA will be the competent authority for most, if not all, AIFMs falling within the scope of the Directive's provisions.⁴⁷

Non-EU passport provisions

- 2.27 The Directive's co-legislators – the Commission, European Parliament and Council – originally intended to create the so-called 'third country' management and marketing passports for non-EU fund managers whether these manage and/or market EU or non-EU AIFs.
- 2.28 The political outcome on this issue is that the Directive provides for a staggered implementation process for the non-EU 'third country' passport provisions. An authorisation and passporting process for non-EU AIFMs will only become available in

46 Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds (December 2011): http://ec.europa.eu/internal_market/investment/docs/venture_capital/111207-proposal_en.pdf and Proposal for a Regulation of the European Parliament and of the Council on European Social Entrepreneurship Funds (December 2011): http://ec.europa.eu/internal_market/investment/docs/social_investment/20111207proposal_en.pdf

47 Further information concerning the coalition government's regulatory reform programme is available at www.hm-treasury.gov.uk/consult_finreg_blueprint.htm

2015 at the earliest, running alongside national private placement regimes which will be permitted to continue as a matter of national law and policy until 2018.

- 2.29** Two years after the Directive comes into effect – i.e. July 2015, ESMA must issue an opinion on the functioning of the EU AIFM managing and marketing passports to the Commission, European Parliament and Council. This opinion must also cover the functioning of any nationally permitted private placement regimes (i.e. in Member States which permit EU and non-EU AIFMs to market and/or manage non-EU AIFs in their territory, as contemplated in articles 36 and 42 of the Directive).⁴⁸ ESMA's opinion must include advice to the Commission on the efficacy of the EU AIFM passport and the viability of creating the non-EU AIFM passport, as contemplated in articles 37-41 of the Directive.
- 2.30** The practical effect of articles 37-41, reliant as they are on a significant number of Commission implementing measures and ESMA technical standards and guidelines⁴⁹, is that Member States will be unable to implement these provisions until such time as they are made to operate following ESMA's opinion and advice to the Commission on the non-EU AIFMs passport⁵⁰ and, secondly, that relevant implementing measures have been adopted. These provisions are not required to be implemented until 2015, at the earliest, and so are not discussed further in this paper.

Authorisation by 22 July 2013 and use of AIFMs passport

- 2.31** Subject to regulatory reform programme contingencies, the FSA (FCA) aims to be in a position to receive potential AIFM applications for authorisation from Q2 2013. This would, *inter alia*, benefit potential FCA-authorized AIFMs wishing to make use of the EU-wide passports for marketing and/or AIF management from 22 July 2013.

⁴⁸ Where a Member State permits national private placement under article 36, it must apply the Directive's full requirements to the AIFM with the exception of the majority of the article 21 depositary requirements. Where a Member State permits private placement under article 42, it must apply the transparency requirements in articles 22-24 to the non-EU AIFM, as well as Section 2 of Chapter V in the case of private equity AIFs under management, where applicable.

⁴⁹ The third country passport provisions contain a significant number of subordinate measures and scope for ESMA guidelines. There are Commission implementing acts in article 37(14), Commission delegated acts in articles 37(15) and 40(11), ESMA guidelines in articles 37(16) and 40(12), ESMA draft regulatory technical standards in articles 37(17), 37(18), 37(23), 40(13), 40(14), and 41(7), and ESMA draft implementing technical standards in articles 37(22), 39(10), 40(16) and 41(8), all relating to the conditions under which the third country passport must operate.

⁵⁰ Articles 67 and 68.

3

Scope

This section covers key matters relating to the scope of the Directive.

- 3.1** The Directive raises a number of questions which are not addressed in subordinate measures, but which nonetheless require clarity for effective national transposition. These questions relate principally to matters of scope. There is, for example, a need to identify appropriate criteria to determine the meaning of ‘joint ventures’ (JVs) and ‘special purpose entities’⁵¹ (SPE), which are not defined terms in the Directive but are expressly stated to be out of scope.⁵²
- 3.2** ‘Holding company’ is a defined term⁵³, but its application must nevertheless be considered in national transposition. There are also questions relating to what extent, if at all, certain listed entities are to be treated under the Directive. Likewise, the extent to which exchange-traded funds or exchange-traded commodities are within scope of the Directive must be considered for transposition purposes.
- 3.3** The UK Authorities may develop criteria to delineate the appropriate perimeter. We believe robust and purposive criteria will provide greater regulatory certainty and avoid the risk of regulatory arbitrage and market distortion. There are a number of elements of the EU framework that will support the Directive.
- 3.4** For example, the Commission is likely to conduct transposition workshops from early 2012. Output from these workshops, such as Commission Q&A or guidance, will need to be factored into any perimeter guidance we propose. Furthermore, ESMA must develop draft regulatory technical standards to determine types of AIFMs, where relevant to the application of the Directive. We will also need to consider any such standards adopted by the Commission when delineating appropriate perimeter boundaries.⁵⁴

51 Article 4(1)(an) defines ‘securitisation special purpose entities’.

52 Recital 8.

53 Article 4(1)(o) (i) and (ii).

54 Article 2(4) provides that Member States shall take the necessary steps to ensure that AIFMs referred to in article 2(1) comply with the Directive at all times.

Who is an AIFM?

- 3.5** A UK fund manager whose regular business activities could fall within the ‘managing AIFs’ definition⁵⁵ in the Directive should provisionally consider itself to be an AIFM and as such expect to be subject to the Directive’s requirements. Fund managers falling with this definition (UK AIFMs) should consider carefully the implications of the Directive for their businesses, notwithstanding that the precise scope, content and extent of its application to them will be contingent on a number of factors. These factors include the Commission’s implementing measures on the ‘Delegation’ provisions⁵⁶ to be adopted during 2012, and the UK Authorities’ position on the article 3 exemptions for AIFMs falling below the specified AUM thresholds.
- 3.6** A significant volume of UK domestic fund legislation will require amendment for consistency with the Directive including amendments to primary and secondary legislation (e.g. the Promotion of Collective Investment Schemes (Exemptions) Order⁵⁷).

What is an AIF?

- 3.7** The Directive contains a fairly broad legal definition of an AIF which seeks to capture any investment fund which does not require authorisation under the UCITS Directive. The Directive also specifies a number of additional elements in the definition, including (i) the raising of capital from (ii) a number of investors (iii) with a view to investing that capital in accordance with a defined investment policy (iv) for the benefit of those investors.⁵⁸
- 3.8** As noted, the Directive makes mention of various types of vehicles, entities and arrangements considered as excluded from the definition of an AIF, or outside the Directive’s scope. These include ‘holding companies’⁵⁹ and ‘securitisation [SPEs]’ which are defined, but also joint ventures and family office vehicles, terms which the Directive does not define.
- 3.9** The explicit exclusion of ‘holding companies’ from scope may be relevant to UK firms carrying on the activities of investment management or trading through vehicles in corporate form. The extent to which holding companies carry on activities potentially subject to the Directive will need to be determined.⁶⁰ These vehicles may include those whose shares are admitted to trading on a regulated market in the EU, not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies.⁶¹

55 Article 4(1)(w).

56 Boxes 63-74 ESMA advice.

57 Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001.

58 Article 4(1)(a).

59 Article 4(1)(o).

60 Recital 8 states that AIFMD ‘should not apply to holding companies as defined’ in the Directive.

61 Article 4(o)(i) and (ii).

Joint ventures

- 3.10** Recital 8 states that the Directive should not apply to a joint venture (JV) but does not define what a JV is. This may reflect the fact that most Member States recognise the principle that a commercial JV between participants actively involved in its management and control will not be considered an AIF (or indeed even a collective investment undertaking). In transposing the Directive's scope provisions, competent authorities will need to consider what characteristics are pertinent to a JV and which distinguish it from the definition of an AIF.⁶²
- 3.11** While, as noted, the Commission may run Directive transposition workshops during 2012 to promote supervisory convergence in Member State transposition on scope, among other matters, we are likely to consider in conjunction with the Treasury to what extent we may develop guidance on JVs.
- 3.12** A possible criterion could be to examine the nature of the relationship between the participants in the business concerned. If all participants are to some extent involved in the day-to-day management of the vehicle, it might be considered a JV and not an AIF. Another criterion might be that a JV not raising capital from the public would exclude it being considered an AIF.
- 3.13** More difficulty arises in relation to a situation in which some of the investors play no part in the running of the venture. Where no capital is raised the entity concerned will not be an AIF.
- 3.14** It is also unclear whether there are other circumstances in which a venture that has passive investors might be taken out of the Directive definition of an AIF, or whether the exclusion in recital 8 envisages that the investors in a JV will all actively participate. The UK Authorities will also need to take into account that the term 'joint venture' does not have a precise meaning and the exclusion for JVs is not contained in the body of the Directive.

Q1: What other criteria could be used to distinguish a JV from an AIF and, in particular, a JV where not all participants are involved in its day-to-day management?

Family investment vehicles

- 3.15** Family investment vehicles are vehicles that invest the private wealth of related investors without the raising of external capital. Recital 7 of the Directive states that these vehicles should not be considered to be an AIF.
- 3.16** We need to identify what distinguishes these vehicles from AIFs. We consider that some of the key elements are that:

62 Article 4(1)(a)(i) and (ii).

- there is a family relationship between the investors;
- the money or assets are in some way connected to the relationship and there is no raising of capital from investors outside of the relationship; and
- the money or assets and the relationship between investors are likely to pre-date the relationship between the investors and the AIF or AIFM.

3.17 We will need to consider giving guidance about what might be considered to be a family relationship. We could, for example, consider that this covers any family relationship recognised by national law.

Q2: How should we look to characterise the ‘family relationship’ between investors?

Q3: Are there other features of a family investment vehicle that might distinguish it from an AIF?

Small AIFMs

3.18 The Directive gives Member States the option to create a *de minimis* or registration regime for those UK AIFMs managing portfolios of AIFs whose assets are below certain AUM thresholds⁶³ (small AIFMs). The relevant value of AUM is dependent on whether the AIFs under management make use of leverage and offer certain redemption rights to investors.⁶⁴

3.19 ESMA’s advice covers how the total value of AUM for the purposes of the article 3 thresholds should be calculated, and also covers the procedures according to which small AIFMs may opt in⁶⁵ to full requirements.

3.20 Small AIFMs are not entitled to rights under the Directive including the management and/or marketing passports⁶⁶ under Chapter VI⁶⁷ unless they opt in to the Directive’s full requirements.⁶⁸ In December the Commission adopted proposals that might allow venture capital⁶⁹ and social entrepreneurship funds⁷⁰ access to a European marketing passport. We

⁶³ Recital 17 and articles 3(2) and 3(4) outline the application of a less stringent regulatory regime with opt-in procedures for smaller AIFM who exceed those AUM thresholds or which wish to benefit from the EU AIF management and/or marketing passport under Chapter VI of the Directive.

⁶⁴ Article 3(2) specifies the thresholds applicable to the ‘*de minimis*’ regime.

⁶⁵ Box 1 and Box 3 of ESMA’s advice respectively set out the calculation of the total value of assets under management and the procedures for opt-in for ‘smaller AIFM’.

⁶⁶ Principally articles 32 and 33.

⁶⁷ Article 3(4).

⁶⁸ Recital 17 and article 3(4) set out the ability of AIFM to opt in to the Directive.

⁶⁹ 2011/0417/ (COD).

⁷⁰ 2011/0418 (COD).

will need to consider the interaction between the Directive and the proposed regulations and how these might impact small AIFMs.

- 3.21** In many cases small UK AIFMs will already be FSA-authorized. For example, this may relate to performing activities such as discretionary portfolio management under MiFID, the provision of venture capital, corporate finance services or the management of UCITS. Apart from the fact that the Directive may restrict the activities an AIFM is able to perform in the future beyond the management of AIFs and UCITS, it nevertheless will remain the case that many small AIFMs may be FSA-authorized for activities other than managing AIFs. A number of small UK AIFMs will not, however, be subject to FSA authorization for any activities other than managing AIFs.
- 3.22** The Directive provides that the '*de minimis*' regime for small AIFMs is without prejudice to any stricter rules adopted by Member States. The Treasury is considering what, if any, stricter requirements it will apply to AIFMs below the article 3 thresholds and how these AIFMs will be regulated.
- 3.23** ESMA has provided advice to the Commission on the procedure and information to be provided as part of the registration process.⁷¹
- 3.24** In its own DP, the Treasury considers the merits and demerits of requiring small AIFMs to seek full authorization.
- 3.25** On the assumption that the FSA, and subsequently the FCA, will be the primary or sole regulator of AIFMs, consideration will need to be given to the procedure for bringing small AIFMs into regulation.
- 3.26** The approach document for the FCA (published June 2011)⁷² sets out information relating to these risks and in particular, the difference in powers the FCA will have when acting as a registrar, as opposed to a regulator of firms, to take appropriate enforcement action to address consumer detriment and penalise a breach of FCA rules by firms.
- 3.27** Requiring smaller AIFMs to be only subject to registration would result in the development of a two-tier regulatory regime for AIFMs distinct from that for other types of firms undertaking fund management-related activities (e.g. UCITS management companies and MiFID investment firms).
- 3.28** This may ultimately result in investors making decisions to subscribe to AIFs on the basis of false perceptions about the regulatory protections from which they will benefit (i.e. they will assume registration confers a greater degree of regulatory protection than is in fact the case).
- 3.29** If the Treasury decides to not require smaller AIFMs to seek authorization but follow a registration process instead, the FCA would seek to address the risk that consumers

71 Box 2 ESMA advice sets out the information to be provided as part of registration of 'smaller AIFM'.

72 Paragraph 2.2 of FCA Approach Document.

misunderstand the distinction between registration and regulation through clear communication and through the public register of firms⁷³ and other channels.

- 3.30** In instances where regulatory risks crystallise, which on an after-the-fact basis the FCA's regulatory powers were deemed to have been insufficient to prevent or manage and the FCA is unable to resolve (e.g. seeking recourse or compensation for investors), this runs the risk of undermining confidence in the regulatory system.
- 3.31** There are a number of important considerations that flow from the use of a register, including whether it is appropriate to acknowledge the difference between the ability of professional investors and retail investors to draw sufficient distinction in the type and form of regulation. This is relevant because although the vast majority of investors in AIFs are likely to be professional, some AIFs will be accessible to retail investors (see the discussion on retail AIFs in Section 9).
- 3.32** Consideration will also need to be given to how the opt-in procedures for small UK AIFMs would operate, in relation to use of the management and/or marketing passports. ESMA's advice provides that the procedures for opt-in should include the submission of information required for authorisation under the Directive not previously provided to the competent authority. To the extent possible, we will seek to develop a distinct application process for small AIFMs seeking to opt in to the Directive.
- 3.33** If the Treasury decided to require small AIFMs to seek FSA authorisation, more consideration would need to be given to the requirements to be applied. An example of this would be applying the approved persons regime (APER) to members of the senior management of the AIFMs, including the requirement to have the full range of controlled function holders.⁷⁴ This consideration would be especially necessary as the Directive does not mandate requirements for persons effectively conducting the business of small AIFM. Persons conducting the business of AIFMs above the article 3 AUM thresholds may be subject to APER requirements at authorisation.⁷⁵ The Treasury will be considering further in its discussion paper.
- 3.34** We will need to consider how best to take a proportionate approach in applying the Directives' requirements to these small firms.

73 The FSA Register contains details of all the firms, individuals and other bodies regulated by the FSA (available from www.fsa.gov.uk/Pages/register/index.shtml).

74 The FSA's Senior Management Arrangements, Systems and Controls (SYSC) sourcebook requires responsibilities for the affairs of a firm to be appropriately apportioned (available from <http://fsahandbook.info/FSA/html/handbook/SYSC>).

75 Article 8(1)(c) sets out the requirement for the persons who effectively conduct the business of the AIFM to be of sufficiently good repute and sufficiently experienced in relation to the investment strategies pursued by the AIFs managed by the AIFM.

- Q4:** (a) Which aspects of the Directive should we consider applying to small UK AIFMs?
- (b) In particular, which aspects of the Directive should we consider applying given that a distinction may be drawn between types of AIF or AIFM?

4

Operating requirements on AIFMs

This section outlines the requirements of the Directive that are applicable to the operation of AIFMs. These include due diligence, the appointment of counterparties, conflicts of interest management, the fair treatment of investors, the remuneration of certain staff, risk management, delegation and the requirement to hold capital and professional indemnity insurance.

General principles

- 4.1 The overarching principles in the Directive draw heavily on those established in MiFID and the UCITS Directive, which in turn are reproduced in the FSA's Handbook including the COLL, SYSC and COBS sourcebooks.
- 4.2 The Directive aims to strike a balance between a level of consistency with the UCITS and MiFID regimes, while taking account of the diversity of AIFs and the different types of assets they invest in.
- 4.3 Given that many AIFMs will already carry out investment activities covered under MiFID and the UCITS Directive, they will already be familiar with our Handbook rules and these general principles. For instance, a number of the rules in COBS 11 on best execution, client order handling and record-keeping, and COBS 2 on dealing with inducements and acting honestly, fairly and professionally are mirrored in ESMA's advice.
- 4.4 The Directive introduces a particular complexity for AIFMs that carry out MiFID investment services and activities. In particular, it provides that an external AIFM may not carry out MiFID investment services and activities unless those services are limited to the MiFID investment services and activities of:

- (individual) portfolio management;
- investment advice;
- safe-keeping and administration in relation to shares or units of collective investment undertakings; and
- reception and transmission of orders in relation to financial instruments.

4.5 In some instances, the limitations on the MiFID investment services and activities that an external AIFM may provide will result in changes for those firms currently authorised under MiFID. Existing MiFID firms and UCITS management companies that consider they will be AIFMs should be aware of several new general principles, such as:

- additional due diligence responsibilities;
- requirements relating to the appointment of counterparties and prime brokers; and
- the introduction of a ‘fair treatment’ definition.

Due diligence

4.6 Although most of the ESMA advice on due diligence mirrors the requirements in the UCITS Directive⁷⁶, it also introduces a number of new requirements that apply when an AIFM is investing in long duration, less liquid assets such as real estate, or partnership interests.

4.7 It is proposed that the new due diligence requirements will include a responsibility on AIFMs to establish a business plan consistent with the duration of the AIFs and market conditions. AIFMs will also need to have in place due diligence policies and procedures that take account of the nature, scale and complexity of the assets invested in. AIFMs will also have an ongoing responsibility for updating their business plans to take account of any material changes in investment strategy or market conditions, and for regularly reviewing and updating their due diligence policies and procedures.

4.8 Although AIFMs will not be required to keep records of every investment opportunity considered by an investor, they will be required to keep records of significant opportunities, as well as detailing the risks identified with any such investments. These record-keeping requirements include a responsibility to retain minutes of meetings, preparatory documentation, as well as economic and financial analysis conducted in assessing the feasibility of a project or contractual commitment.

⁷⁶ Article 23 of Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company.

Appointment of counterparties and prime brokers

- 4.9 AIFMs will be responsible for exercising due skill, care and diligence when selecting and appointing counterparties and prime brokers, including considering the full range and quality of services offered.
- 4.10 The ESMA advice on selection and appointment sets out the minimum criteria for selecting prime brokers and counterparties. This includes a requirement that such entities: should be subject to ongoing supervision by a public authority; are financially sound; and have the necessary organisational structure for the services provided.⁷⁷ This is in respect of over-the-counter derivative transactions, securities lending or repurchase agreements.⁷⁸

Fair treatment

- 4.11 Authorised firms will already be familiar with their responsibility to treat customers fairly under Principle 6: *a firm must pay due regard to the interests of its customers and treat them fairly*.⁷⁹ In 2007/8 we published further guidance on what fair treatment of customers means for managers of CIS.⁸⁰ Although the guidance in 2007/8 related to retail consumers, it is envisaged from the FCA Approach Document that professional investors would also be considered to be consumers.
- 4.12 In its advice to the Commission, ESMA recognises that fair treatment by an AIFM requires a degree of subjectivity on the part of the assessor and it has therefore elected not to set out a prescribed definition of what fair treatment means in practice. ESMA's approach recognises that most national regulatory frameworks contain a principle of fair treatment, and that introducing a strict definition may well prevent competent authorities from taking the necessary steps to prevent consumer detriment where it is evident from the circumstances of a particular case that an investor has not been treated fairly.
- 4.13 ESMA's approach to fair treatment is based on the underlying principle that no investor should obtain preferential treatment having an overall material disadvantage to other investors. However, it is recognised that fair treatment does not prevent AIFMs from treating certain customers differently, such as 'seed' investors having better terms than those who invest later.
- 4.14 The Directive permits AIFMs to offer investors preferential treatment provided that such treatment presents no overall material disadvantage to other investors and this preferential treatment has been adequately disclosed.
- 4.15 Introducing harmonised criteria for assessing the fairness of firms' actions would undoubtedly provide greater certainty, but would also come at the cost of removing the existing degree of flexibility in making such assessments.

77 Box 13 ESMA advice.

78 Box 13.3 ESMA advice.

79 FSA Principles for Businesses.

80 PS07/11: *Responsibilities of Providers and Distributors for the fair treatment of customers – Feedback on DP06/4 and Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers* January 2008.

- Q5:** What factors should be considered when assessing the fair treatment of consumers, especially where some investors in a fund have received preferential treatment?
- Q6:** Do you agree that fair treatment of retail consumers should equally apply to professional investors?

Conflicts of interest

- 4.16** The Directive requires an AIFM to take all reasonable steps to identify conflicts of interest that might arise between it and various parties in the course of managing an AIF.⁸¹ The AIFM will need to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflicts of interests. They will also need to segregate, within their own operating environment, tasks and responsibilities that may be regarded as incompatible or that may generate systematic conflicts of interest. Should any of these arrangements prove insufficient to ensure against damage to investors' interests, the AIFM must make appropriate pre-sale disclosure of this fact to potential investors before undertaking investments on their behalf.
- 4.17** SYSC 10 in the FSA Handbook sets out conflicts of interests requirements for firms, including specific provisions for UCITS management companies and common platform firms. The FSA requirements are broadly aligned with the Directive provisions and ESMA's advice in relation to:
- the types of conflicts that may occur;
 - the policies that must be put in place;
 - independence in conflicts management;
 - record-keeping and disclosure obligations; and
 - strategies for exercising voting rights.
- 4.18** Firms should in particular note the examples of conflicts of interest indicated in ESMA's advice.⁸²
- Q7:** What organisational arrangements might raise particular issues for UK AIFMs? Do these requirements pose particular difficulties for private equity firms in the light of their distinct business model?

81 Article 14.

82 Box 20 ESMA advice

Remuneration

- 4.19** The Directive contains provisions for remuneration policies for AIFMs.⁸³ The purpose of the policies is to promote sound and effective risk management and not encourage risk-taking that would be inconsistent with the risk profile and rules of the managed AIF.
- 4.20** Annex II of the Directive sets out the detailed principles which need to be followed when establishing and applying remuneration policies in respect of those staff whose professional activities have a material impact on the risk profiles of the AIF under management. These principles reflect those which already apply to those firms which come within the scope of the Capital Requirements Directive 3 (CRD3) and which take account of the principles on sound remuneration policies in the financial services sector set out in the Commission's recommendation.⁸⁴
- 4.21** The purpose of the remuneration provisions is that AIFMs manage risk and control risk-taking behaviour by reducing the potential adverse impact of poorly defined remuneration schemes. There is, in addition, a proportionality principle whereby the detailed guidelines on the remuneration policies will take into account the size of the AIFM and of the AIF they manage, their internal organisation and the nature, scope and complexity of their activities. The guidelines to be developed by ESMA must comply with the principles in Annex II.
- 4.22** Work on the detailed guidelines for the remuneration provisions has not yet commenced, so at this stage it is not possible to comment substantively on those guidelines or their implementation. A key challenge will be to develop appropriate mechanisms for implementation that meet the overall objectives of the Directive and its commitment to a proportionate approach. They will also need to reflect the particular structures of AIFMs, including in relation to remuneration policies.

Q8: What are the major challenges in the development of remuneration guidelines appropriate to the structure of AIFMs?

- 4.23** The determination of which firms come within the scope of the Directive and which do not, will also affect the development of remuneration rules. Some MiFID firms currently subject to the CRD3 rules may become AIFMs and subject to the Directive's requirements. Some will be regulated for the first time under the Directive and some, potentially, will be subject to both the CRD3 and the Directive's rules.
- 4.24** Our transposition of the Directive will need to take full account of the requirements of CRD3, which have been implemented in the UK through the Remuneration Code. This will include the 'tiering' of firms, which determines the scale of remuneration requirements and supervision. A core objective for us will be to determine how the remuneration rules for

⁸³ Recitals 24 to 29, Article 13 and Annex II of the Directive.

⁸⁴ Recommendation 2009/384/EC of April 2009.

AIFMs can most appropriately be aligned to those that currently apply to CRD3 firms. This will require consideration of a range of options for implementation. These could include:

- bringing AIFMs within the scope of our existing Remuneration Code.⁸⁵ This would require considering, for example, the extent to which the current tier structure would be appropriate in ensuring that the disclosure requirements in the Directive would be met; and
- developing a Remuneration Code to apply specifically to AIFMs but modelled closely on the existing code. This would ensure that rules specific and appropriate to AIFMs would be in place but this option would also introduce an additional layer of complexity in that two codes would need to be managed, and some firms might find themselves subject to both.

Q9: What options could be considered for implementing the remuneration requirements of the Directive that would achieve fair and appropriate alignment with the existing Remuneration Code?

4.25 The AIFM that are significant in terms of their size or the size of the AIF they manage, their internal organisation and the nature, scope and complexity of their activities, will be required to establish a remuneration committee to exercise competent and independent judgement on remuneration policies and practices and the incentives created for managing risk. The chair and members of the remuneration committee should be members of the management body who do not perform any executive functions in the AIFM concerned.⁸⁶

Q10: What are the practical issues for potential AIFMs in establishing a remuneration committee?

Organisational requirements

4.26 The Directive sets out the general principles relating to organisational requirements. An AIFM will be required at all times to use adequate and appropriate human and technical resources necessary for the proper management of an AIF.⁸⁷ In particular the AIFM must have sound administrative and accounting procedures, controls and safeguards for electronic data processing, and adequate internal controls, including particular rules for personal transactions by its employees.

⁸⁵ SYSC 19A of the FSA Handbook.

⁸⁶ Annex II, paragraph 3.

⁸⁷ Article 18.

- 4.27** ESMA's advice seeks to achieve an appropriate level of consistency between the requirements of the Directive and the requirements set out in the UCITS Directive and MiFID, taking into account the diverse nature and characteristics of AIFs.⁸⁸ However, there is likely to be a level of overlap of requirements between these directives.
- 4.28** Proportionality is a fundamental principle in the approach to organisational requirements. AIFMs should be able to implement these requirements proportionately to their size, nature, scale and complexity of their business.
- 4.29** However, irrespective of the size of its business, an AIFM will need to establish a permanent compliance function⁸⁹ although⁹⁰ whether that function operates separately from other AIFMs functions will be determined by application of the proportionality principle. For example, having to appoint a separate compliance officer may be a disproportionate requirement for a small AIFM.
- 4.30** The AIFM will need to establish an internal audit function.⁹¹ Where it is considered disproportionate to have an internal audit function, in its approach the AIFM may rely on another business unit of the AIFM to meet the relevant requirements of the Directive.⁹²

Q11: What criteria should be used to determine whether it is disproportionate to require an AIFM to have a separate compliance function? What criteria should be used to determine whether it is disproportionate for an AIFM to establish an audit function?

Q12: As organisational requirements are also covered by other Directives relevant to fund management, such as MiFID and the UCITS Directive, will any potential overlap with these Directives create any problems?

Risk management

'Functional and hierarchical' separation or safeguards

- 4.31** The Directive requires functional and hierarchical separation of an AIFM's risk management function from its other functions, including that of portfolio management.⁹³ ESMA's advice sets out the condition that would satisfy this test.⁹⁴

88 Box 44 ESMA advice.

89 Box 48 permits the activities related to the compliance function to be carried on by a third party.

90 Box 49 ESMA advice.

91 Box 50 ESMA advice.

92 Box 50 ESMA advice, and explanatory text paragraph 18.

93 Article 15.

94 Box 30 ESMA advice.

- 4.32** We will need to review a UK AIFM's approach to the separation of the risk management function in line with the principle of proportionality, and with the understanding that in any event the UK AIFM must be able to demonstrate that specific safeguards against conflicts of interest allow for the independent performance of risk management activities.
- 4.33** Where it is considered disproportionate for the risk management function to be functionally and hierarchically separate from the AIFM's other functions, ESMA's advice sets out the criteria we should take into account when considering the safeguards to ensure the independent performance of the risk management function. These safeguards must include the following conditions:
- the use of data that is reliable and subject to an appropriate degree of control;
 - risk management staff are compensated in accordance with the performance of the risk management function and independent of the performance of other business areas in which they are engaged;
 - independent decision-making; and
 - the segregation of conflicting duties.
- 4.34** These safeguards may also take into account that there is a review of the risk management function by an independent external third party or by the internal audit function, where this exists.
- 4.35** An AIFM's risk management arrangements should be reviewed at a set frequency proportionate to its size and business activities but not less than once a year. ESMA's advice sets out certain specific circumstances that would also trigger a review.⁹⁵
- 4.36** SYSC 7.1.6R and SYSC 7.1.7R set out the requirements for an FSA firm designated as a 'common platform firm'⁹⁶ (for example, a bank or a MiFID firm) to establish an appropriate risk management function. If a common platform firm is to be subject to this Directive, it may need to review its risk management functions to ensure that it meets the Directive's requirements.⁹⁷

Q13: In what circumstances would you be unable to meet the requirement to have functional and hierarchical separation of your risk management function and would need to rely on having appropriate safeguards?

95 Box 27 ESMA advice.

96 A common platform firm is defined in the FSA Handbook as a firm that is: (a) a BIPRU firm; (b) an exempt CAD firm; (c) a UK MiFID investment firm which falls within the definition of 'local firm' in Article 3.1 of the CAD; or (d) a dormant account fund operator.

97 See also COLL 6.3.11R which contains similar requirements currently applicable to UCITS managers.

Systems and governance arrangements

4.37 The Directive and ESMA advice detail minimum requirements for systems and governance arrangements required of AIFMs.⁹⁸ These arrangements include:

- appropriate policies and procedures;
- consistency between risk profile and risk limits;
- periodic reporting to those tasked with governance;
- stress-testing; and
- sufficient and appropriate risk-monitoring systems.

At a high level, the risk management requirements that AIFMs must observe are broadly similar to those under the UCITS Directive in that they set out the governance and operational arrangements that need to be in place so that risks can be properly identified, measured, managed and monitored on an ongoing basis.

4.38 The similarities between the two Directives suggest that the considerations will be the same, drawing heavily on the UCITS Directive. However, there are areas of material difference, for example, on setting investment risk limits.

4.39 The Directive, unlike the UCITS Directive, does not directly limit the investments or strategies that an AIF may employ. An AIFM is required to establish an internal framework of limits that are in line with the risk profile of the AIF⁹⁹ that has been disclosed to investors.¹⁰⁰ Depending on investment strategies, AIFMs must be able to set quantitative and/or qualitative limits. Where only qualitative limits are used, the AIFM will need to justify its approach to us. This justification might include the reasons why it was difficult to set meaningful quantitative risk limits or why using quantitative risk limits may not be in the best interests of investors.

Q14: For what reasons might the use of a qualitative, not a quantitative, risk limit, be in the interests of AIF investors?

Leverage and collateral

4.40 Leverage is one issue that might be factored into an assessment of risk. The Directive requires AIFMs to set a maximum level of leverage for each AIF under management. This maximum level should be decided against a number of key business factors, including investment strategy, the types of AIF under management, and the need to limit the exposure of an AIF to a single counterparty.¹⁰¹ AIFMs must be able to demonstrate that the self-imposed leverage

98 Article 15.3.

99 Box 29 ESMA advice.

100 Article 23(4)(c).

101 Article 15(4).

limits are adhered to for each AIF. When applying for authorisation, an AIFM will be required to provide us with information relating to their policy on the use of leverage in accordance with article 7.3 of the Directive. Furthermore, where there is a material change to maximum leverage levels¹⁰², this must be disclosed to investors.¹⁰³

- 4.41** Collateral is also used within leveraging arrangements and an AIFM will need to understand and set the extent to which its prime broker or other counterparty has the right to re-use such assets.

Q15: What constitutes a 'material change' to the maximum level of leverage set for an AIF may vary according to changes in the market. What factors should we take into account in determining what constitutes a material change?

Q16: A material change to the maximum leverage limit set by an AIFM must be disclosed to investors and to us. Operationally, what will be the best way to report this to us?

Delegation

- 4.42** Investment managers make extensive use of delegation – or outsourcing – to manage internal costs and make use of external expertise. We consider here the rules the Directive requires for firms' delegation/outsourcing arrangements and third-party contracts, and what these mean for investment managers who are increasingly delegating more of their functions to third-party service providers.
- 4.43** The Directive recognises that AIFMs wishing to increase the efficiency of the conduct of its business may choose to delegate the responsibility for the performance of some of its functions.
- 4.44** UK-authorized investment managers are already required to comply with the Handbook requirements for general outsourcing. Investment managers – when relying on a third party for the performance of operational functions critical for the performance of regulated activities, listed activities or ancillary services, on a continuous and satisfactory basis – must ensure that they take reasonable steps to avoid undue additional operational risk.¹⁰⁴ The Handbook guidance explains that a firm should notify us when it intends to rely on a third-party service provider.¹⁰⁵
- 4.45** The Directive, however, imposes stricter notification requirements on AIFMs intending to outsource some of its activities. While this regime is not significantly different to that

102 Box 109 ESMA advice.

103 Article 23(5)(a).

104 SYSC 8.1.1R (1) for general outsourcing requirements.

105 SYSC 8.1.12G and SUP 15.3.8G.

required by MiFID, it does require advance notification to the competent authorities *before* delegation arrangements may become effective. It also imposes requirements in relation to functional and hierarchical separation within the AIFM, where portfolio or risk management is delegated to an entity that may have conflicting interests to the AIFM or the investors of the AIF.

Q17: What are the particular challenges for your firm as a result of the delegation requirements? How will this affect existing operational structures?

Capital requirements and professional indemnity insurance

- 4.46** AIFMs subject to FSA authorisation are required to comply with a minimum capital requirement. This requirement varies according to the nature of the AIFM's activities. This includes whether the AIF under the AIFM's management is internally managed or, if the AIFM is external, whether it also manages a UCITS and whether it provides investment services such as individual portfolio management.
- 4.47** The Directive sets out the calculation of a core set of capital requirements¹⁰⁶ together with the possibility to hold professional indemnity insurance (PII) to cover the liability arising from the crystallisation of specified risks.¹⁰⁷ In summary, the Directive requires that:
- Internally managed AIF must have initial capital of at least €300,000.
 - Externally appointed AIFMs must have initial capital of at least €125,000. They must also have additional own funds equal to 0.02% of the amount by which the portfolio of AIFs exceeds €250 million, subject to an overall limit in the requirement of €10 million.
 - The portfolio of AIFs only includes those AIFs for which the firm is the appointed AIFM and excludes assets managed by the AIFM on a delegated basis from another AIFM.
 - The own funds of the AIFM must exceed the fixed overheads requirement of article 21 of the Capital Adequacy Directive (CAD).
 - Both externally appointed AIFMs and internally managed AIFs must have either additional own funds or PII to cover potential liability risks arising from professional negligence. ESMA's advice addresses the risks that must be covered and the minimum amounts of additional capital or PII required.
 - Own funds must be invested in liquid assets or assets readily convertible to cash in the short term and should not include speculative positions.

¹⁰⁶ The term 'capital requirements' is used in this paper to refer to initial capital and own funds as set out in Article 9.

¹⁰⁷ Article 9(7) sets out the option to hold professional indemnity insurance against liability arising from professional negligence.

- 4.48 AIFMs that also manage UCITS are not subject to the above requirements other than the need to have additional own funds or PII to cover professional liability risks. AIFMs can also manage portfolios of investments for clients on a discretionary basis and provide investment advice, safekeeping and administration services, or receive and transmit orders, in connection with that management service, provided they have sufficient initial capital in accordance with the CAD.
- 4.49 The Directive's capital requirements will not apply to small AIFM under a registration regime. Small AIFM may, however, choose to opt-in to the Directive's full authorisation requirements in which case the capital requirements will apply.
- 4.50 External AIFMs are currently subject to the following requirements, which are dependent on their other regulated activities:
- Those that also provide investment services under MiFID are subject to the capital requirements either of IPRU (INV)¹⁰⁸ chapter 9 (if they are an exempt CAD firm) or GENPRU¹⁰⁹ and BIPRU¹¹⁰ if they are a BIPRU investment firm (which includes a UCITS investment firm¹¹¹).
 - Those firms that only operate UCITS (and other CIS) are UCITS firms and subject to UPRU.¹¹²
 - Those firms that only operate CIS outside the scope of the UCITS Directive are subject to IPRU (INV) chapter 5.
- 4.51 Following the transposition of the Directive we expect that there will be at least six prudential categories of AIFM (excluding smaller AIFMs). Note that the terms below are descriptive only, in order to assist with identifying types of AIFM at this stage. We will not necessarily use these descriptors for implementation or as Handbook definitions.
- **Internal AIFMs** – managing a single AIF for which the AIF itself has been authorised as the AIFM and subject to a €300,000 initial capital requirement and the requirement to have additional own funds or PII to cover potential liability risks arising from professional negligence.
 - **External AIFMs** – appointed by or on behalf of one or more AIFs and subject to a €125,000 initial capital requirement, the additional own funds requirement based on portfolios under management, and the requirement to have additional own funds or PII to cover potential liability risks arising from professional negligence.
 - **AIFM investment firm** – an external AIFM which also provides the core service of individual portfolio management subject to the requirements for external AIFM and BIPRU Limited Licence Firm requirements.

108 IPRU (INV) is the Interim Prudential sourcebook for Investment Businesses.

109 GENPRU is the General Prudential sourcebook.

110 BIPRU is the Prudential sourcebook for Banks, Building Societies and Investment Firms.

111 A UCITS investment firm is one that operates UCITS and also undertakes limited MiFID-scope activities including individual portfolio management.

112 UPRU is the Prudential sourcebook for UCITS Firms.

- **AIFM investment firm** – an external AIFM which also provides the core service of individual portfolio management and will be a BIPRU limited licence firm subject to the requirements for an external AIFM.
- **UCITS AIFM firm** – an external AIFM which is also designated as a management company for one or more UCITS and subject to the UCITS Directive initial capital and own funds requirements and the Directive requirement to have additional own funds or PII to cover potential liability risks arising from professional negligence.¹¹³
- **UCITS AIFM investment firm** – a UCITS AIFM firm which additionally provides the core service of individual portfolio management and will be a BIPRU limited licence firm subject to the requirements for a UCITS AIFM firm.

4.52 In addition to the prudential categories above, the existing categorisation of UCITS management companies not also acting as external AIFMs will remain unaffected by the transposition of the Directive. We will also need to consider the appropriate categorisation of smaller AIFMs opting in to the Directive and fund managers operating CIS that are not AIFs.

Q18: Do you have any comments on our analysis as to how we expect the capital and PII requirements to apply to the different types of firm acting as managers of AIFs?

Use of IPRU (INV) for the new rules

4.53 We will need to set out the capital and PII requirements for Internal AIFMs, External AIFMs and UCITS AIFM firms in a Prudential sourcebook. At present the requirements for UCITS firms are in UPRU. We suggest it would be preferable to put the requirements for all these firms in the same sourcebook and the two alternatives are to include them either in UPRU or IPRU (INV).¹¹⁴

4.54 We expect that IPRU (INV) will be used by the Financial Conduct Authority (FCA), which will regulate AIFMs and UCITS management companies after the changes introduced by the Regulatory Reform Programme. The majority of firms subject to the Directive are likely currently to be subject to Chapter 5 of IPRU (INV) so will be familiar with its structure and contents. Using IPRU (INV) would also mean that we would need one fewer Prudential sourcebook for the FCA (as we would no longer need UPRU) and we therefore suggest that it would be the appropriate location for these rules.

Q19: Do you agree that it would be appropriate to set out the requirements for UCITS firms and UCITS AIFM firms in IPRU (INV)?

113 Article 9(10) sets out that the Own funds or PII requirement of Article 9.7 shall apply to AIFMs which are also UCITS management companies.

114 It should be noted that when the capital requirements for UCITS management companies were implemented in 2003 they were located in chapter 7 of IPRU (INV).

The use of indemnities

- 4.55** The Directive allows the UK authorities to permit UK AIFMs to provide up to 50% of the required additional own funds with a guarantee. This must be from a credit institution or an insurance undertaking that has a registered office either in an EU Member State or in a third country with equivalent prudential regulations.
- 4.56** At present, an AIFM subject to chapter 5 of IPRU (INV) can use a qualifying undertaking from a bank or holding company to meet part of its financial resources requirement provided it is in the form specified in the rules. We are not aware that many, if any, firms use this facility and therefore it is not clear that there is likely to be any great demand for the use of guarantees as contemplated by the Directive. So, to make the most efficient use of our resources we propose only to develop rules that allow the use of guarantees if firms tell us that they wish to use them.
- 4.57** It should be noted that, although the UCITS Directive also allows a Member State to let a UCITS management company meet the additional own funds requirement in a similar way, when we implemented those requirements we chose not to incorporate such a provision based upon the responses that we received to our consultation.¹¹⁵

Q20: Do you expect to want to use a guarantee to meet part of the additional own funds requirement?

Coverage of risks arising from professional negligence

- 4.58** The Directive requires an AIFM to have either additional own funds or hold PII to cover potential liability risks arising from professional negligence.¹¹⁶ ESMA's advice sets out the risks that these resources must cover¹¹⁷ and furthermore determines the own funds that should be held by the AIFM.¹¹⁸
- 4.59** ESMA's advice would also permit us to alter the value of own funds that an AIFM should hold to ensure liability risks are sufficiently captured. If the advice was adopted as subordinate measures by the Commission, we would need to determine the criteria that must be met by an AIFM to permit a lower value of own funds to be held and also when we would require an AIFM to increase its own funds.
- 4.60** Aspects of this part of the Directive are similar to the Pillar 2 framework applicable to BIPRU Limited Licence Firms. We will consider the extent to which it is appropriate to apply elements of our approach under this framework to AIFMs. This will include the (UCITS) AIFM investment firms that will be BIPRU Investment Firms and therefore subject to this Pillar 2 framework.

115 CP06/10.

116 Article 9(7).

117 Box 5 of ESMA advice.

118 Box 7 of ESMA's advice sets out that the additional own funds requirement for liability risk is equal to 0.01% of the value of the portfolios of AIF managed by the AIFM.

4.61 We will also compare the PII requirements with those that we apply to other firms¹¹⁹ to ensure that we implement them appropriately given the nature of the UK market for PII and draw on the previous observations we have made in the context of our Pillar 2 work.¹²⁰ The ESMA advice makes no reference to potential policy exclusions and we will assess whether it is possible for AIFMs to obtain cost-effective PII cover that complies with the minimum requirements of the Directive.

Q21: Do you have any comments on how AIFMs might comply with any PII requirements adopted in Commission implementing measures based on the ESMA advice?

Q22: To what extent do you expect to use PII as part of the required financial resources to cover professional negligence risks?

Requirements for internally managed AIFs

4.62 The Directive requires an internally managed AIF to have initial capital of at least €300,000¹²¹ and specifies that such an AIF should also have either additional own funds or hold PII to cover potential liability risks arising from professional negligence.¹²²

4.63 It is not absolutely clear whether the other requirements of Article 9 of the Directive apply to internally managed AIFs but our view, on a purposive reading, is that they do not and we therefore do not expect to apply them. This is because such an approach would be consistent with the requirements for internally managed funds under the UCITS Directive. It also does not appear appropriate to apply the requirement for an AIFM to hold additional own funds¹²³ if such funds should only be invested in liquid assets¹²⁴ as this would unfairly penalise funds whose objective includes investing in assets that are illiquid.¹²⁵

4.64 Therefore we currently expect that we will not require the internally managed AIFs to hold additional own funds based on the funds under management. We also expect not to introduce the fixed overheads requirement of Article 21 of the CAD.

119 Chapters 9 and 13 of IPRU (INV) apply PII requirements to exempt CAD firms and personal investment firms respectively. Chapter 3 of MIPRU applies PII requirements to insurance intermediaries and home finance intermediaries.

120 ICAAP submissions – observations for Limited Licence Investment Firms (available from www.fsa.gov.uk/pubs/other/icaap.pdf)

121 Article 9(1) sets out that ‘Member States shall require that an AIFM which is an internally managed AIF has an initial capital of at least €300,000’.

122 Article 9(7).

123 Article 9(3) specifies how an additional amount of own funds calculated based on the value of the portfolios of the AIFM is to be calculated.

124 Article 9(8) specifies the requirements for own funds to be invested in liquid assets or assets readily convertible to cash in the short term and shall not include speculative positions.

125 However internally managed AIFs will be subject to the additional own funds or PII requirement of Article 9.7 and any such funds will need to be invested in liquid assets.

- 4.65** The rules for internally managed AIFs will be subject to the usual consultation processes and we also expect to consider the current regulatory regimes that are applied in other Member States for internally managed AIFs. We understand that there are two such distinct models.
- 4.66** One model requires the promoter of the AIF to hold the required minimum level of capital. The other applies the requirement directly to the AIF. There are potential challenges with both approaches. It will not always be the case in the UK that there is a promoter. And if we apply the requirement directly to the AIF then there may be practical problems in distinguishing between the capital that can be used for the initial capital requirement, and the capital representing investors' interests in the funds. There will also likely be issues to consider for partnerships or funds more generally without a separate legal personality.
- 4.67** The definition of initial capital is as set out in the CAD. AIFMs will need to be able to meet this requirement at all times. Because the Directive applies both an initial capital and additional own funds requirement, we suggest that the ongoing requirement will need to be expressed in the rules in terms of own funds. This would be a proportionate calculation of capital resources, and is consistent with the approach to the requirements currently applied to other firms within the scope of the CAD and UCITS Directive.¹²⁶
- 4.68** We expect that our approach to the additional own funds or PII requirement will also be consistent to that applied to external AIFMs.

Q23: Do you have any comments on the most appropriate approach to determine the prudential requirements for internally managed AIFs?

Cross-reference to the CAD

- 4.69** Some requirements in the Directive include terms defined in the CAD. In particular there are references to initial capital and own funds which are used as measures of financial resources and the fixed overheads requirement which is in Article 21 of the CAD.
- 4.70** When we develop our proposed requirements, we will consider the current interpretations of these terms as set out in UPRU and GENPRU for UCITS firms and UCITS investment firms respectively. This will include the most appropriate way in which to express the Directive's combination of an initial capital and an additional own funds requirement.
- 4.71** We will also need to take into account the changes currently being made to the CAD to ensure that they are properly reflected in our rules. These changes include an increase in the minimum proportion of own funds that must be in the form of Tier 1 capital and the introduction of capital buffers. The CAD will also be split so that some of the requirements are included in a regulation that will apply directly to the firms within its scope.

¹²⁶ For further discussion please refer to Section 9 in relation to internally managed listed AIFs.

Q24: Do you have views on the intended meaning of CAD-defined terms and our approach to incorporating them in the rules for AIFMs?

5

Management requirements on AIFMs

This section outlines those requirements of the Directive applicable to the management of AIFs. These include the requirements for proper and independent valuation, liquidity management, leverage and investment in securitisation positions.

Valuation

Proper and independent valuation

- 5.1 The Directive requires an AIFM to ensure that appropriate and consistent procedures are in place for the proper and independent valuation of the assets of each AIF under management.¹²⁷
- 5.2 ESMA's advice acknowledges that there are currently no common valuation standards due to the diverse nature of AIF assets and the differing requirements in different jurisdictions.¹²⁸ It has proposed general principles to help an AIFM meet its valuation obligations.
- 5.3 Investment managers that currently manage authorised investment funds are subject to certain FSA requirements relating to valuation.¹²⁹ We will need to consider the compatibility of those requirements applicable to AIF with the requirements of the Directive.

Who can perform the valuation function?

- 5.4 An AIFM must ensure that the valuation function is performed either by itself or an external valuer.

127 Article 19(1).

128 Section IV and VIII ESMA advice, and Introduction.

129 COLL 6.3 sets out detail of valuation and pricing to ensure that authorised fund managers pay due regard to their clients' interests and treat them fairly. It provides rules and guidance on valuing the scheme property and the price of units (COLL 6.3.6G).

5.5 Where the AIFM itself performs the valuation function, it must ensure functional independence from the portfolio management function and ensure that there are sufficient safeguards in place to prevent any conflicts of interest arising, including in relation to remuneration policies (see also Section 4). Furthermore, we may require that the valuation procedures and/or valuations be verified by an external valuer or, where appropriate, an auditor.¹³⁰

External valuer

5.6 The obligation on the AIFM to ensure proper and independent valuation applies even if the valuation function is performed by an external valuer.

5.7 Where an external valuer is appointed, the AIFM must be able to demonstrate to us that:

- the external valuer is subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct¹³¹;
- the external valuer can provide sufficient professional guarantees to be able to effectively perform the valuation function; and
- the appointment of the external valuer complies with certain conditions of delegation.

5.8 We will need to consider what professional guarantees by an external valuer would be sufficient to show that it can meet the requirements of the Directive.

5.9 ESMA's advice considers that the valuation function refers only to the valuation of individual assets. For example, a fund administrator or price provider calculating Net Asset Value (NAV) should not be considered to be an external valuer unless it also provides valuations for individual assets.

5.10 ESMA's advice makes clear that where more than one external valuer is appointed for an AIF, the AIFM must make sure that valuation procedures are applied consistently.¹³²

5.11 The AIFM's liability to the AIF is not affected by the fact that an external valuer has been appointed. The external valuer is liable to the AIFM for any losses suffered by the AIFM as a result of the external valuer's negligence or intentional failure to perform its tasks. This liability is irrespective of any contractual arrangements providing otherwise.

Q25: What are the most significant considerations that we should take into account when assessing the need to require AIFMs to have their valuation procedures and/or valuations verified by an external valuer or auditor?

130 Article 19(9).

131 Article 19(5) (a).

132 Box 57 ESMA advice.

Q26: What professional guarantees by an external valuer would be sufficient to show that it can meet the requirements of the Directive?

Calculation of Net Asset Value (NAV)

- 5.12** ESMA's advice sets out general requirements when calculating the NAV per unit or share but does not prescribe the methodology for the calculation, as this may be governed by national law or prescribed by the AIF rules or instruments of incorporation.
- 5.13** Based on our discussions with industry, we understand that there are investor participations in a fund, such as equity or partnership interests in a private equity fund, that are not evidenced by the usual concept of holding a share or unit in that fund. Where this is the case, we will need to consider how the NAV calculation should apply to these funds.

Q27: How should the NAV calculation requirement apply to an AIF that does not use the 'share'/unit' concept?

Liquidity management

- 5.14** During the financial crisis increased redemption requests and illiquid markets resulted in considerable liquidity risks for several business models. Many sectors experienced net outflows of funds while some firms that were unable to exit illiquid investments activated gate provisions to limit withdrawals, while others offered lower fees in exchange for longer lock-up periods. Clearly, liquidity management is an important feature of an effective and stable AIF market.
- 5.15** Article 16 of the Directive and the supporting ESMA advice set out the prescribed requirements on liquidity management for all open-ended AIFs and those AIFs which use leverage. Both the Directive and the ESMA advice cover two separate aspects of liquidity management:
- AIFM responsibilities to investors; and
 - AIFM responsibilities to counterparties.

General principles

- 5.16** Although UK-authorized investment managers are currently subject to different Handbook liquidity requirements, depending on the firm's particular activities, the Directive expressly requires AIFMs to have systems and procedures in place to manage and monitor liquidity

risk within the AIF¹³³, and to ensure that the liquidity profile of the investments of the AIF complies with the underlying obligations to investors.

- 5.17** The heterogeneous and diverse nature of the population of AIF within the scope of the Directive presents significant challenges to specifying the detailed mechanics or procedures for the management of liquidity. In its advice, ESMA identifies general requirements for all AIFMs, which can be adapted to the diverse size and structure of the AIFM and to the nature of the AIF under management.
- 5.18** The advice includes requirements on AIFMs to:
- implement and maintain appropriate liquidity measurement arrangements;
 - monitor the liquidity profile of the portfolio of the AIF's assets;
 - identify, manage and monitor conflicts of interest arising between investors;
 - implement appropriate policies and procedures to ensure that redemption terms are disclosed to investors, in sufficient detail and with sufficient prominence, before they invest and in the event of material changes;
 - put into effect tools and arrangements necessary to manage the liquidity risk of each AIF under its management;
 - regularly conduct stress tests in both normal and exceptional liquidity conditions; and
 - document and review their liquidity management policies and procedures, and include escalation measures in these policies and procedures.
- 5.19** The overarching principle is that investors should be able to redeem their investments in accordance with the AIF's policy, which should cover conditions for redemption in both normal and exceptional circumstances, and in a manner consistent with the fair treatment of investors. This should capture the appropriate use of gates, suspensions and side pockets.
- 5.20** ESMA has not attempted to identify all the tools and arrangements¹³⁴ which may be used, or determine in what circumstances the different tools could be used, or indeed what constitutes normal and exceptional liquidity conditions.¹³⁵ The use of tools and arrangements to manage liquidity will vary according to the nature, scale and complexity of the AIF. In any event, ESMA is clear that AIFMs should be able to demonstrate to their competent authorities that appropriate and effective liquidity management policies and procedures are in place.
- 5.21** ESMA's advice on the use of tools and arrangements, in both normal and exceptional circumstances, combines a principles-based approach with adequate disclosure requirements. The advice also recognises the use of special arrangements as one type of tool

133 Article 16(1) which excludes unleveraged closed-ended AIFs.

134 Such tools and arrangements may include gates, partial redemptions, temporary borrowings, side pockets, notice periods (i.e. 'cut off' dates ahead of 'dealing points'), pools of liquid assets and suspensions.

135 ESMA's advice makes clear that suspensions would only ever occur in exceptional circumstances.

available for managing liquidity. Special arrangements could include the use of side pockets and other mechanisms where certain assets of the AIF are subject to a bespoke or separate arrangement from the general redemption rights of investors.¹³⁶

- 5.22** The requirement regularly to conduct stress tests in both normal and exceptional circumstances recognises that it may not always be appropriate to prepare quantitative calculations and, where this is the case, a qualitative assessment should be performed. ESMA advises that the frequency of stress-testing will depend on the investment strategy, liquidity profile, type of investor and the redemption policy of the AIF. However, it is expected that tests will be conducted at least annually.
- 5.23** While proportionality may be applied, AIFMs must be able to demonstrate to the FSA that appropriate and effective liquidity management policies and procedures are in place. The Commission subordinate measures will likely require additional transparency by AIFMs over the types of circumstances where tools and arrangements will be used to manage the liquidity risk of each AIF under its management.
- 5.24** Firms need to consider the extent to which they already have in place systems and procedures to obtain and process the underlying information required to implement the liquidity provisions of the Directive, particularly those related to stress-testing and measurement of the liquidity profile of assets.
- 5.25** AIFMs intending to invest in illiquid instruments should consider, pre-launch, the use of redemption restrictions and appropriate subscription/redemption frequency and ensure that the dealing frequency selected is appropriate for their investment strategy and assets. AIFMs should ensure that they retain the tools that they require to ensure that effective liquidity management is possible.
- 5.26** Although the Directive does not set out prescribed liquidity measures, our existing rules for NURS provide for the limiting or delaying of redemptions¹³⁷ in certain circumstances.

Q28: Are there any particular challenges for your firm as a result of the liquidity requirements?

Leverage

- 5.27** The Directive defines ‘leverage’ as a method by which the AIFM increases the exposure of an AIF it manages, whether through borrowing of cash and securities or leverage embedded in derivative positions or by any other means.¹³⁸ ESMA’s advice considers ‘leverage’ as the additional exposure gained through any form of contractual or other legal relationship that

136 Box 31 ESMA advice.

137 COLL 6.2.19- 6.2.22.

138 Article 4(1)(v).

gives the AIF the opportunity to earn greater returns or suffer greater losses than would otherwise have been the case.¹³⁹ This can be viewed as covering a broad range of transactions that might be carried on by an AIF or an AIFM on behalf of an AIF. For example, a manager on behalf of a hedge fund which agrees financing from a prime broker results in the AIF being leveraged.

- 5.28** The Directive makes clear that, in relation to private equity and venture capital funds in particular, leverage at the level of the portfolio company (i.e. a private company held as an investment by the private equity fund) should not be included in the calculation of that AIF's exposure. ESMA's advice states that, nevertheless, when the AIFM looks at an AIF's leverage levels, it will need to 'look through' corporate structures that affect the AIF through any form of AIF cross-collateralisation or guarantee.
- 5.29** ESMA's advice on the general provisions for calculating the leverage of an AIF states that borrowing arrangements that are temporary in nature and covered by capital commitments from investors need not be included in the leverage calculation – for example, where there is temporary bridge financing used by private equity to support the purchase of a company while investor commitments are drawn down. We will need to consider what 'temporary' should mean in this instance.
- 5.30** There are five key areas in the Directive covering leverage and requiring the AIFM to:
- set out its leverage policy;
 - set a maximum level of leverage for each AIF under its management;
 - disclose leverage levels to investors;
 - disclose leverage levels to the FSA for each AIF in relation to which the AIFM employs leverage on a substantial basis; and
 - demonstrate to the FSA that leverage levels set for each AIF are reasonable and that the AIFM complies with limits at all times.
- 5.31** The requirements to set a maximum leverage and to disclose leverage levels to investors and the FSA will require the leverage levels of each AIF to be calculated in accordance with methods set out in the Directive.

Q29: What criteria should we take into account when considering whether arrangements of capital commitments might be temporary in nature?

139 Box 94 ESMA advice.

Calculating leverage

5.32 ESMA's advice sets out the detail of these calculation methods.¹⁴⁰ There are three methods by which the leverage of an AIF should be calculated, which are in summary:

- **Gross method** – the sum of the absolute values of all an AIF's positions excluding leverage positions that are considered to be risk neutral.
- **Commitment method** – allows netting and hedging so that risks of a trade can be netted/offset against the risks of another leaving no material residual risk.
- **Advanced method** – subject to certain preconditions, including prior notification to us, this allows amongst other things consideration of estimated maximum losses and additional offsetting of positions.

5.33 In all instances where the Directive requires the calculation of leverage, the AIFM will be required to carry out its calculations using at least both the Gross and the Commitment methods. The Gross and Commitment methods are substantially based on the commitment approach that is set out in the CESR Guidelines of the calculation of global exposure for UCITS.¹⁴¹

5.34 Where the AIFM considers that neither of these two methods provides a fair reflection of the levels of leverage within a given AIF, the AIFM may also make use of the 'Advanced method' of calculating leverage. This will be in addition to using both the Gross and Commitment methods, and provided that the AIFM has notified¹⁴² us that it intends to use this method. In its advice, ESMA has indicated that it intends to provide more detailed guidelines on the Advanced method of calculation.¹⁴³

Q30: In what instances do you consider that neither the Gross nor Commitment methods of leverage calculation would provide a reasonable or approximate reflection of leverage within an AIF?

Limits and other supervisory restrictions on the use of leverage by AIFM

5.35 The Directive introduces a new dimension to regulation in relation to the supervision of the use of leverage by AIFMs. AIFM must set a maximum level of leverage for each AIF under management¹⁴⁴ and must disclose this level to potential investors in a given AIF.¹⁴⁵ AIFMs will also need to keep investors regularly informed on the levels of leverage used in relation

140 Box 94-100 ESMA advice.

141 www.esma.europa.eu/documents/overview/10?title=&doc_reference=§ion=223&doc_type=207&x=41&y=2

142 Box 94 and 97 ESMA advice.

143 Pages 17 and 478 of ESMA advice.

144 Article 15(4).

145 Article 23(1)(a).

to the AIF in which they have invested, and any changes to the maximum levels of leverage that AIFMs have set.¹⁴⁶

- 5.36** AIFMs must demonstrate to regulators that these self-set leverage levels are reasonable and that they abide by them. Where AIFMs employ leverage on a substantial basis they must make available to their regulator certain information about the overall level of leverage employed for each managed AIF.¹⁴⁷ The AIFM will have to make an assessment for each EU AIF that it manages and for each AIF it markets in the EU about whether leverage is being employed on a substantial basis. ESMA's advice sets out a non-exhaustive list of criteria that might be used for this assessment, which includes, among other things, the nature, scale and complexity of the AIF, the investment strategy, liquidity and counterparty risk.¹⁴⁸ We will need to be informed of the outcome of the assessment and may request a copy of the assessment.
- 5.37** In addition, the Directive requires competent authorities to assess the risks that use of leverage by AIFMs could pose to the financial system. Under certain conditions and according to specified procedures, the FSA may exercise supervisory powers on the use of leverage by an AIFM or group of AIFMs to limit the extent to which this contributes to the build-up of systemic risk in the financial system or the risk of disorderly markets.
- 5.38** As part of the workings of the ESFS, competent authorities must inform ESMA and the ESRB of any proposed supervisory action in relation to a single AIFM or group of AIFMs.¹⁴⁹ Where applicable, the competent authority of the AIF concerned must be informed as part of EU-wide supervisory cooperation.
- 5.39** ESMA's advice sets out the process and illustrative circumstances where competent authorities might make use of these supervisory powers.¹⁵⁰ These circumstances include where exposure arising through the use of leverage by an AIFM could constitute an important source of market, liquidity or counterparty risk to a financial institution, in particular where such an institution is deemed systemically relevant or where the use of leverage could contribute to the downward spiral in the prices of financial instruments.
- 5.40** Supervisory action may be taken in relation to a single or group of AIFMs. We consider that this supervisory task is in line with our existing regulatory objectives of ensuring financial stability and market confidence. On completion of UK regulatory reform in 2013, it is envisaged that the FCA will have this supervisory task in line with its market integrity objective.
- 5.41** As set out in the coalition government's White Paper on regulatory reform, one of the Financial Policy Committee's (FPC) macro-prudential roles will be to identify and monitor systemic risks to the stability of the financial system, including those created by unsustainable

146 Article 23(5).

147 A break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives and the extent to which an AIF's assets have been reused under leveraging arrangements (Article 24(4)).

148 Box 101 ESMA advice.

149 Articles 25(3), 25(4)-25(8).

150 Box 101 ESMA advice.

levels of financial sector leverage.¹⁵¹ The coalition government has proposed that the FPC would have access to a number of ‘levers’ in the discharge of its role, including making recommendations to the FCA or where explicitly provided for by certain macro-prudential tools the power to direct the FCA to take action in relation to a group of AIFM. The FCA may also exercise its supervisory powers on the use of leverage over a single or group of AIFMs independently of the FPC.

Investment in securitisation positions

- 5.42 The Directive sets out rules which will apply to UK AIFMs investing in securitisation positions on behalf of AIF under management (e.g. asset-backed securities).¹⁵² ESMA’s advice covers more detailed components of this part of the Directive including in relation to due diligence, risk management and liquidity management.¹⁵³
- 5.43 One of the stated objectives of the requirements is to ensure ‘cross-sectoral consistency’. As such the Directive’s requirements are based on a set of parallel provisions in the CRD¹⁵⁴ and Solvency II.¹⁵⁵ These other Directives refer to investment in securitisation activities undertaken by other types of EU-regulated entities (credit institutions and insurance undertakings respectively) in seeking to avoid any possibility for regulatory arbitrage, and to maintain a level playing field among market participants. ESMA has considered the extended guidelines published by the EBA on article 122a of the CRD¹⁵⁶ and by CEIOPS¹⁵⁷ on article 135 of Solvency II in developing its technical advice to the Commission.
- 5.44 One of the core tenets of this aspect of the Directive, noted in ESMA’s advice, is the requirement that an AIFM should only assume exposure to tradable securities and other financial instruments based on repackaged loans if the originator, sponsor or original lender has explicitly disclosed that it will retain, on an ongoing basis, a net economic interest that must not be less than 5%. ESMA has further noted that the requirement that the net economic interest should not be subject to any credit risk mitigation or any short positions or any other hedge and should not be sold. ESMA’s advice also incorporates certain exemptions, notably for securitised exposures fully, unconditionally and irrevocably guaranteed by central governments or central banks, or transactions based on a clear, transparent and accessible index.

151 Para 2.27, www.hm-treasury.gov.uk/d/consult_finreg_new_approach_blueprint.pdf

152 Article 17 sets out the rules that apply to ‘investment in securitisation positions’.

153 See Section IV.VI of ESMA’s advice.

154 Article 122a of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (referred to as CRD) (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF>)

155 Article 135 of Solvency II.

156 Guidelines on Article 122a of the CRD (available from www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf).

157 https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP63/CEIOPS-L2-Advice-Repackaged-loans-investment.pdf

- 5.45** ESMA's advice sets out the obligations of AIFMs in cases where the requirements for the relevant party to a securitisation transaction (i.e. the relevant originator, sponsor or original lender) are breached, including the requirement for AIFMs to take corrective actions, taking into account the best interests of the AIF investors. By way of comparison, it is notable that in such cases the CRD envisages the application of an additional regulatory capital charge for the relevant securitisation position held by credit institutions.¹⁵⁸
- 5.46** ESMA's advice also draws in other aspects of the Directive, including the requirements for investment in securitisation positions to be properly reflected in an AIFM's risk management and liquidity management procedures. This includes ensuring the AIF managed by the AIFM is able to meet its underlying obligations, the performance of regular stress tests on securitisation positions taking into consideration the dynamic effects of such tests on the remaining assets and unsecuritised positions of the relevant AIF, and the reporting of exposures to senior management.
- Q31:** What aspects of the proposed requirements for investment in securitisation positions present the most significant challenges and/or create the most significant degree of uncertainty for AIFMs, including in relation to the interaction with the existing requirements applicable to credit institutions and insurance undertakings?
- 5.47** The Directive sets out that the requirements for investment in securitisation positions apply to AIFMs investing in positions issued after 1 January 2011 on behalf of AIFs. Consistent with the advice provided by CEBS in respect of the CRD, ESMA's advice contemplates that, from 31 December 2014, the requirements for investment in securitisation positions should be applied where new underlying exposures are added or substituted after that date.
- Q32:** Do you anticipate any particular issues or challenges arising from the grandfathering provisions for investment in securitisation positions?
- 5.48** The Directive also applies the requirements on investment in securitisation positions to UCITS.¹⁵⁹ This will include the future subordinate measures to be adopted by the Commission.¹⁶⁰ The UK Authorities will seek to create one set of common rules that would apply to both AIFMs and UCITS (and, as relevant, to UCITS management companies).

158 Article 122a(5) of CRD (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF>)

159 Article 63 sets out amendments to the UCITS Directive to apply the requirements relating to investment in securitisation positions.

160 Box 43 of ESMA's advice refers to the applicable subordinate measures to UCITS.

6

Transparency

This section considers the transparency requirements to be imposed on AIFMs under the Directive's provisions on annual reporting, disclosure to investors and reporting to competent authorities.

- 6.1** A key policy objective underpinning AIFM regulation is to increase considerably the transparency required of AIFMs in relation to investors and competent authorities. The Directive sets certain safeguards and requirements to ensure that AIF investors receive a sufficient level of information and are kept informed of any material changes to that information to consider any impact on their investment and risk decisions.
- 6.2** The Directive lays down minimum requirements for annual reporting, disclosure required to investors before investment decisions are made and then on an ongoing basis, and reporting to competent authorities.

Disclosure to investors

- 6.3** AIFMs are required to make available certain information to investors before they invest in an AIF. Article 23 does not prescribe any format for this.
- 6.4** The overall disclosure requirement will vary according to AIF type and to the extent it is already subject to other EU disclosure requirements, such as those contained in the Prospectus Directive. In addition, AIFs authorised in a Member State will be subject to national requirements where these apply.¹⁶¹ UK-authorized funds (NURS and QIS), will be subject to any additional FSA rules that apply.
- 6.5** Our disclosure requirements for professional investors in a QIS are similar to those in the Directive.¹⁶² The difference is more in the level of detail of our requirements. We will need

161 Recital 10.

162 COLL 8.3.4R.

to avoid any duplication of requirements¹⁶³ and consider what additional requirements need to be implemented as part of transposition.

Retail investors

- 6.6 Article 43 permits Member States to allow the marketing of an AIF to *retail investors*¹⁶⁴ and permits Member States to impose stricter requirements than those contained in the Directive. The information below only concerns the marketing of UK-authorized AIF to retail investors.¹⁶⁵
- 6.7 UK-authorized AIF (NURS) must comply with our pre-sale investor disclosure rules. These will be the key features document requirements¹⁶⁶ unless the firm opts for the simplified prospectus requirements¹⁶⁷ or the key investor information requirements.¹⁶⁸
- 6.8 Our domestic disclosure requirements aim at strong protection of retail investors by ensuring they are furnished with relevant and up-to-date detailed information.
- 6.9 The Directive covers areas similar to those covered by our current disclosure requirements, for example, requirements on disclosure of investment strategy, valuation procedures, risk management procedures, and the identification of the depositary. However, it differs concerning the level of detail, and the format of the disclosure that is prescribed.
- 6.10 We need to consider whether the additional FSA disclosure requirements for NURS should be maintained after AIFMD implementation. We will need to consider the compatibility of the NURS disclosure requirements with the applicable Directive provisions.

Q33: Do you agree that our existing disclosure requirements for NURS should be maintained?

Disclosure of preferential treatment

- 6.11 An area that the Directive targets for mandatory disclosure concerns the fair treatment of investors. AIFMs must describe how they ensure the fair treatment of all investors, especially in relation to situations where an investor, or sub-set of investors, has received preferential treatment.
- 6.12 AIFMs will be required to disclose how they will ensure the fair treatment of all investors in relation to each EU AIF managed and/or marketed.¹⁶⁹ AIFMs must also identify the type

163 See also Section 9 'Categories of AIF and specialised regimes' in the section on 'Qualified Investor Schemes'.

164 Article 4(1)(aj) defines 'retail investor' as one 'who is not a professional investor'.

165 See also Section 9 'Categories of AIF and specialised regimes' and 'Retail AIFs' in that section.

166 COBS 13.3.

167 COLL 4.6.8R.

168 COLL Appendix 1EU KII requirements.

169 Article 23(1)(j).

of investors who obtain preferential treatment and, where this is relevant, the investors' economic or legal links to it or the AIFs concerned.

- 6.13** We consider this most likely to be relevant where an AIFM has agreed or proposes to issue units or shares under different terms. This is sometimes facilitated through the use of 'side letters' in the case of hedge funds. Side letters generally offer some investors preferential treatment in return for their investment and can include benefits such as reduced fees and waived lock-up or redemption periods. Other forms of preferential treatment might concern more favourable performance or management fees.
- 6.14** FSA firms have a responsibility to treat all customers fairly¹⁷⁰, including professional investors. Our views on what could amount to 'fair treatment, were considered in PS07/11¹⁷¹ and more specifically in our document *Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers* published in 2008.
- 6.15** If the Commission adopts implementing measures on the basis of ESMA's advice on fair treatment¹⁷² we will need to consider whether our existing fair treatment requirements need further clarification for professional investors.

Disclosure obligations relating to liquidity arrangements

- 6.16** The Directive includes a number of quite specific disclosure requirements relating to liquidity management.¹⁷³ AIFMs will be required periodically to disclose:
- the percentage of assets subject to special arrangements which may have been put in place due to the illiquid nature of certain assets; and
 - any new arrangements for managing AIF liquidity.
- 6.17** ESMA's advice¹⁷⁴ provides more detail on the liquidity management disclosure requirements.

'Special arrangements'

- 6.18** ESMA's advice defines 'special arrangements'¹⁷⁵ for the purpose of liquidity management. It sets out: (i) how the percentage of assets subject to 'special arrangements' should be calculated; and (ii) the frequency of disclosure and minimum disclosure requirements to investors (including disclosure relating to the valuation methodology applied to the

170 Principle 6 of the FSA's Principles for Businesses PRIN 2.1.1R (available at <http://fsahandbook.info/FSA/html/handbook/PRIN>).

171 Page 23 of PS07/11 says 'As a minimum we would expect acceptable market practice to be for managers to ensure that all investors are informed when a side letter is granted and any conflicts that may arise are adequately managed.' See www.fsa.gov.uk/pubs/discussion/fs06_02.pdf

172 Box 19 ESMA advice.

173 Article 23(4).

174 Box 108 ESMA advice.

175 In Box 31 of ESMA's advice 'special arrangements' are defined as 'an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impact the specific redemption rights of investors in a type of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors'

‘special arrangements’ and how the management and performance fees apply to these arrangements).

- 6.19 ESMA considers that ‘special arrangements’ include the situation where ‘side pockets’ and other mechanisms specifically identifying AIF assets have been ring-fenced and made subject to separate arrangements. It considers that it would not, however, include the suspension of an AIF as it would not constitute a separate or bespoke arrangement, but rather an ‘arrangement’ that applies to all the AIF assets and all AIF investors.

New arrangements

- 6.20 ESMA highlights the ongoing obligation on AIFMs to maintain the liquidity management arrangements applicable to managed AIFs which are not unleveraged, closed-ended AIFs. They must notify investors of any material change to those arrangements. ESMA’s advice defines ‘material change’ as any change in information which causes a reasonable investor to reconsider its investment in the AIF concerned.
- 6.21 ESMA advises that AIFMs should be required to notify investors as soon as any ‘special arrangements’ for managing liquidity are used for unleveraged, closed-ended AIFs. AIFMs will also be required to notify investors immediately where AIFMs activate gates, side pockets or similar special arrangements, or where they decide to suspend redemptions.

Risk profile and management

- 6.22 ESMA’s advice on mandatory periodic disclosure requirements includes placing a responsibility on the AIFM to disclose the current risk profiles of AIFs. This periodic disclosure should include measures to assess any sensitivity in an AIF portfolio against the most relevant risks to which AIFs could potentially be exposed. Where these risk limits have been exceeded the disclosure should also cover details of the circumstances and any remedial action taken.
- 6.23 ESMA’s advice takes account of the diverse nature of AIFs. It notes that the disclosure required should be proportionate and will vary depending on other factors, including investment strategy and asset class.
- 6.24 ESMA has noted that investors should also have access to information relating to the main features of the risk management system employed by AIFM to manage the risks to which the AIF may be exposed. This information should be made available to investors before investment and when material changes occur.

Frequency of disclosure

- 6.25 ESMA’s advice on the required frequency of liquidity management disclosure requirements is intended to be consistent with an AIFM’s periodic reporting to investors.

Disclosure relating to AIFM use of leverage

- 6.26** Article 23(5) sets out specific disclosure requirements where an AIFM manages and/or markets AIFs in relation to which it uses leverage. Disclosure here covers:
- any changes to the maximum level of leverage the AIFM may employ on the AIF's behalf;
 - any right to the re-use of any collateral or any guarantee granted under the leverage arrangements; and
 - the total amount of leverage employed by the AIF.¹⁷⁶

Q34: Subject to the minimum disclosure requirements in article 23, do you consider that our existing QIS disclosure requirements should be maintained?

- 6.27** The Directive does not prescribe the format of investor disclosure to be made by AIFMs. Disclosure may vary according to the type of AIF and, as noted, some AIFs may already be subject to other requirements, such as those contained in the Prospectus Directive.
- 6.28** AIFMs will be required to provide a minimum level of information for each AIF managed and/or marketed in the EU. Detailed disclosure provisions are set out in article 23 and mostly follow existing disclosure requirements in the Prospectus Directive and UCITS Directive.

Annual reporting

- 6.29** The annual reporting provisions aim to ensure that investors and regulators remain properly informed about the financial and business affairs and risk profiles of AIFs under management.¹⁷⁷ While the Directive does not specify much detail in the annual reporting requirements, it does list a minimum set of mandatory information to be provided to investors, competent authorities of the AIFMs, and, in some circumstances also the competent authority of the AIFs.
- 6.30** The minimum 'package' of required information required for the annual report for each AIF managed or marketed in the EU must contain:
- a balance sheet or statement of assets and liabilities;
 - an income and expenditure account for the relevant financial year;
 - a report on the activities of the relevant financial year;
 - a list of any material changes to the information previously disclosed to investors, during the period covered by the report;

¹⁷⁶ See also Section 5 Management requirements on AIFMs, and the section on Leverage.

¹⁷⁷ Article 22.

- the total amount of remuneration for the relevant financial year, split 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; and
- 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.¹⁷⁸

- 6.31** In its advice on the content and format of the annual report, ESMA has recognised that different national and international accounting standards will apply. ESMA has taken the view that, where conflict or dissimilarity exists between different accounting standards, AIFMs must ensure that the accounting rules applicable to an AIF provide investors with relevant and timely information in an appropriate format.
- 6.32** Different accounting standards may give rise to conflict between accounting rules relating to the items required to be listed on the balance sheet depending on the jurisdiction. Recognising this ESMA's advice does not seek to introduce a harmonised list of items for inclusion, but has rather provided a non-exhaustive list of examples for inclusion in the annual report.
- 6.33** AIFMs must also provide a report on the AIF activities over a given financial year. ESMA has advised that this report should be fair and balanced, providing investors with information on the AIF's investment activities, and identifying also the principal investment and economic risks the AIF faces.¹⁷⁹
- 6.34** In relation to the inclusion of information relating to total remuneration¹⁸⁰ ESMA's advice also recognises the potential for disclosing proprietary information, especially in relation to AIFMs or AIFs having a small and more readily identifiable number of risk-takers¹⁸¹ whose professional activities might have a material impact on the risk profile of the AIFMs or AIFs under management. Acknowledging this concern ESMA has advised that the activities report should be set at a reasonably high-level.

Disclosure of remuneration

- 6.35** Articles 22 (e) and (f) AIFMD introduce new requirements on AIFMs for disclosure of remuneration. This must be disclosed in the AIF's annual report. The information must cover the total amount of remuneration in a given financial year, split into fixed and variable remuneration, paid by the AIFM to its staff and number of beneficiaries. Where relevant, the AIFM must disclose carried interest paid by the AIF. The annual report must also contain the aggregated amount of remuneration broken down by senior management and members of staff whose actions have a material impact on the risk profile of the AIFM or the AIF.

178 Article 22(2).

179 Box 106 ESMA advice.

180 Article 22(2)(e).

181 Known as 'Remuneration Code staff' in SYSC 19A.3.4R of the FSA Handbook. See <http://fsahandbook.info/FSA/html/handbook/SYSC/19A/3>

6.36 Like with other information contained in the annual report, AIFMs must provide this remuneration information to their competent authorities on request.¹⁸² AIFMs must also make this remuneration data available to the competent authority of the AIF where requested to do so.¹⁸³

Q35: What are the implications, if any, of the remuneration disclosure requirements for those firms already subject to the provisions of the FSA's Remuneration Code?

Q36: What are the implications for firms currently outside the Remuneration Code e.g. real estate funds and private equity firms?

Reporting obligations to the FSA

6.37 One of the Directive's core objectives is to enhance the ability of regulators to identify, assess, monitor and manage systemic risk effectively. To this end, AIFMs are required to provide certain information regularly to us on each AIF under their management.

6.38 We currently conduct the Hedge Fund Survey (HFS) and Hedge Fund as Counterparty Survey (HFACS)¹⁸⁴ to assess potential systemic risk to financial stability posed by hedge funds. Both surveys are voluntary and conducted every six months. They provide insight into the two main channels of systemic risk for hedge funds: (i) market dislocations that disrupt liquidity and pricing; and/or (ii) losses in hedge funds which may then lead to losses by banks and other counterparties. The surveys are conducted with larger hedge funds that have significant AUM and the prime brokers who act as counterparty to these funds.

6.39 The HFS asks selected FSA-authorized investment managers about AUM with more targeted and detailed questions for managed hedge funds with more than \$500m in NAV. The HFS captures around 50 investment managers managing more than 100 hedge funds. In contrast, the HFACS covers 14 large FSA-authorized banks having significant dealings with hedge funds either through prime brokerage and/or through businesses generating counterparty credit exposures. The HFACS asks about the size, channel and nature of the larger credit counterparty risks that individual banks may have to hedge funds.

6.40 Some firms that currently participate in the HFS will be AIFMs and, as such, subject to the requirements under the Directive to report certain information to the FSA. The reporting obligations under the Directive will extend the scope of the HFS by capturing data on a

182 Article 24(3)(a) read with article 22(1).

183 Article 22(1).

184 The most recent results from the HFS and HFACS were published in July 2011 (www.fsa.gov.uk/pubs/other/hedge_fund_report_july2011.pdf)

significantly larger population of fund managers. The reporting of the data will not be voluntary and the threshold for inclusion of firms will be lower. The requirements will also target a greater range of AIFMs, for example, private equity fund managers, and will be broader in scope, collecting a broader range of information.

- 6.41** Although the Directive sets out detailed reporting requirements, it also recognises the need for a proportionate approach to distinguish the systemic risk that different-sized AIFMs could pose and thus the frequency with which relevant information needs to be reported by AIFMs.
- 6.42** AIFMs will be required to report regularly to us on the principal markets and instruments in which they trade on behalf of AIFs, as well as on the principal exposures and concentrations in AIF portfolios. For each AIF managed and or marketed in the EU, the Directive provides a list of required information.¹⁸⁵
- 6.43** We will be able to request AIFMs to provide the annual report for each AIF managed and/or marketed in the EU. The AIFM may also be required to provide on a quarterly basis a detailed list of all AIFs under management. ESMA's advice states that this – and other information – is to be provided no later than one month after the end of the relevant reporting period. Where the AIF is a fund of funds this period may be extended by an additional 15 days.¹⁸⁶
- 6.44** We may require further information on a periodic and on an *ad hoc* basis for the purposes of monitoring systemic risk effectively. In exceptional circumstances, ESMA may ask us to impose additional reporting requirements on UK AIFMs.
- 6.45** In terms of format for reporting, ESMA's advice considers that the IOSCO template for hedge fund¹⁸⁷ reporting could be used as a starting point. The concepts in the IOSCO template have been expanded upon by ESMA, for example, to capture the diversity of AIF and used in the *pro-forma* reporting template attached in Annex V of its advice. ESMA proposes that AIFMs provide the required information in accordance with the *pro-forma* template.
- 6.46** There may be some flexibility for AIFMs to provide this in a different format, or to a different frequency at the discretion of the relevant competent authority.¹⁸⁸ It is currently envisaged that for firms reporting to us the GABRIEL data system will be used to collect additional information. It is also likely that we will examine a number of existing data items, including FSA038 and FSA041¹⁸⁹, presently being submitted by some firms who might become AIFMs.

185 Article 24(1).

186 Box 110 ESMA advice, paragraph 2.

187 IOSCO template for the global collection of hedge fund information 25 February 2010.

188 Box 110 ESMA advice, explanatory text.

189 See www.fsa.gov.uk/Pages/Doing/Regulated/Returns/IRR/gabriel/system/drg/index.shtml

Q37: Reporting by third country AIFMs marketing AIFs in the UK will need to be captured. There is no current process for this. What do you believe would be a practical solution for this?

Frequency of reporting

6.47 In its advice, ESMA proposes that the frequency of reporting should vary proportionately according to the size of the AIFM, taking account of whether any article 3 thresholds apply. This may range from quarterly to at least annually. It is worth noting that the content to be reported will also vary according to the threshold level contained in article 3.

Reporting on use of leverage

6.48 AIFMs employing leverage on a ‘substantial’ basis in relation to AIF under management must make available to us a variety of information detailing these leverage arrangements.¹⁹⁰

6.49 Use of leverage is a complex matter. Due to the heterogeneous population of AIFs under management ESMA has recognised that it would not be appropriate to specify a quantitative threshold at which leverage would be considered ‘substantial’.

6.50 In its advice ESMA proposes that a distinction be drawn based on whether the degree of leverage employed could contribute to the build-up of systemic risk in the financial system or risks disorderly markets. A non-exhaustive list of criteria has been provided to assist an AIFM in making an assessment of whether leverage is being employed on a substantial basis.¹⁹¹

6.51 When there is a material change in the use of leverage, the AIFM concerned will be required to carry out a new assessment about whether the level of leverage it employs is substantial in accordance with the methods of calculation of exposure of an AIF.¹⁹²

Other considerations

6.52 Firms will need to consider the extent to which they have in place the information required to be disclosed to investors and reported to competent authorities for the purposes of meeting the Directive’s full transparency requirements.

190 Article 24(4).

191 Box 111 ESMA advice and explanatory text.

192 Box 94 ESMA advice.

7

Depository

Section 7 covers the Directive's requirements for depositaries. It describes which entities may act as depositaries, the depository's main duties of cash-monitoring, safe-keeping of AIF assets, oversight functions, particular requirements for non-EU AIF, segregation of assets by a sub-custodian, and depository liability.

Who can be a depository?

- 7.1** A UK AIFM will be required to ensure that a single depository is appointed for each UK AIF it manages. A UK AIF must have a depository established in the UK.¹⁹³ The Directive gives some discretion to the UK Authorities, however, to allow, until 22 July 2017, a UK AIF to use a depository established in another Member State.¹⁹⁴
- 7.2** Non-EU AIFMs marketing EU or non-EU AIF are not required under Article 42 to have a depository. UK AIFM marketing non-EU AIF are not required to have a single depository, but are required to ensure one or more entities are appointed to carry out certain depository functions (see section 'Requirements for UK AIFM marketing non-EU AIF' and Section 8).
- 7.3** The following three categories of firm may be a depository:
- an authorised EU credit institution;
 - an authorised EU MiFID investment firm providing the service of safekeeping and administration of financial instruments and that meets prescribed prudential requirements¹⁹⁵; and
 - a prudentially regulated firm, subject to ongoing supervision, of a type that (at the date the Directive entered into force (21 July 2011)) is eligible to be a UCITS depository under the UCITS Directive.

193 Article 21(5).

194 Article 61(5).

195 Subject to Article 20(1) of CAD including capital requirements for operational risks and authorised in accordance with Directive 2004/39/EC.

- 7.4 The term depositary in the third bullet of the previous paragraph will include both the depositary of an OEIC and a trustee of an authorised unit trust. We believe only a small number of firms will fall into this category. This number will not increase as the Directive will prohibit any more firms from acting in this capacity (although firms falling into the existing categories may be permitted to act as depositaries of UCITS).
- 7.5 We understand that these types of firms will typically be in a banking group. Some may have a non-EU parent company. In some cases, the UK firm may delegate the safekeeping of assets to a non-group company, sister company, its parent or a UK branch of its non-EU parent.
- 7.6 We currently require a firm whose business consists solely of acting as trustee or depositary of authorised investment funds to have own funds of at least £4m.¹⁹⁶ As this requirement has not been updated, even for inflation, since 1988, and with the increased liability placed on depositaries by AIFMD to immediately return financial instruments in certain instances (see section ‘Depositary liability’), we will need to consider whether the current requirement needs to be changed. Options available for calculating a new requirement could include a flat rate increase in line with inflation; average of a firm’s net income¹⁹⁷, or a percentage of AUM of the AIF for which the depositary is appointed.
- 7.7 In addition to the three categories of firms permitted to act as a depositary, a Member State may permit other entities to act as a depositary for AIF that:
- have no redemption rights exercisable during a five-year period from the date of the initial investments; and
 - generally either do not invest in financial instruments that must be held in custody, or invest in issuers or non-listed companies to potentially acquire control.
- 7.8 In this case, the depositary must be an entity that carries out depositary functions as part of its professional or business activities in relation to which it is subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct. It must also be able to provide sufficient financial and professional guarantees to enable it to perform the relevant depositary functions effectively and meet the commitments inherent in those functions.
- 7.9 We consider that this option may be useful to private equity or real estate AIFs. We are at this stage, however, unaware if any bodies such as lawyers, accountants or fund administrators will seek to offer these depositary services. Nevertheless, we consider this option could give rise to reduced costs and increase competition in this market, so the UK Authorities are considering making use of this Member State option. If the UK does make use of it, we will need to consider what is deemed ‘sufficient financial and professional guarantees’ for these types of firms. We will also need to consider if any other FSA rules should apply to these firms.

196 IPRU-INV 5.2.3(3)(a)R.

197 This method would be consistent with the approach used to calculate a firm’s operational risk requirement under the BIPRU basic indicator approach.

- Q38:** While a depositary is a feature of FSMA-authorized funds (including NURS), the requirement to ensure the appointment of a depositary for unregulated CIS represents a change for UK AIFMs. What additional costs and benefits might this change give rise to?
- Q39:** Should the capital requirements for depositaries within the third bullet of paragraph 7.3 of this DP be increased, and if so, what approach should be taken? What role could insurance have in supplementing this requirement? Where the depositary is within a group, to what extent would a parent stand behind its subsidiary in the case of a default and/or loss of assets?
- Q40:** Are there any bodies (e.g. lawyers, accountants or fund administrators) that intend to offer depositary services to the type of AIF in paragraph 7.7 of this DP? What would be an appropriate prudential regime for these types of depositary and what level of financial or professional guarantees should be given? Should we apply any other FSA requirements to these depositaries?

Duties of a depositary

7.10 The depositary has three primary functions:

- cash monitoring¹⁹⁸;
- safekeeping of an AIF assets¹⁹⁹; and
- oversight of certain operational functions.²⁰⁰

7.11 The UK Authorities are considering making the necessary legislative changes to distinguish between the activity of being a depositary from other activities associated with the management or operation of AIF and CIS.²⁰¹

198 Article 21(7).

199 Article 21(8).

200 Article 21(9).

201 Article 51, Financial Services and Markets Act (Regulated Activities) Order 2001.

Cash monitoring

- 7.12 ESMA's advice²⁰² takes the position that the duty to ensure an AIF's cash has been properly booked in one or more cash accounts should apply to all the AIF's cash and not be limited to subscriptions. Their proposed requirements look to ensure that the depositary has access to all the relevant information for it to carry on this function and to strengthen this further, an obligation is imposed on the AIFM to ensure that the depositary receives timely and accurate information from any third party where the cash account is opened.
- 7.13 On the appointment of the depositary the AIFM should inform it of all existing cash accounts and subsequently of any new cash accounts opened. The depositary should be provided with all information about cash accounts directly by the entity holding the cash account so that the depositary has a clear overview of the AIF's cash flow. In addition, the depositary must carry out reconciliations to ensure that the subscription proceeds tally with the orders received and the units or shares created. It will also be required to check regularly that the AIF's accounting record is consistent with the total number of outstanding units or shares.
- 7.14 We consider that a depositary, in complying with existing FSA requirements, in particular COLL 6.6.4R (General duties of the depositary), will mostly already be carrying on the key reconciliation activities contemplated by the Directive and currently applicable for UK-authorized funds. For example, a depositary must take reasonable care to ensure that the authorised fund manager can demonstrate compliance with the requirements of COLL 6.3 (Valuation and pricing). We consider, therefore, that in practice there may be little or no change to existing practices for these types of depositaries. These requirements, however, will be new for a depositary of an unauthorised AIF.

Q41: Do you agree with our view that a depositary, in having to meet its existing FSA requirements, may already be carrying on most or all of the Directive requirements in relation to monitoring cash flow? If you disagree, what costs and benefits do you consider the Directive requirements will impose?

Safe-keeping of AIF assets

- 7.15 The Directive divides assets into 'financial instruments that can be held in custody' and 'other assets'. ESMA's advice defines a financial instrument that can be held in custody as an instrument that:

202 Box 77-78 ESMA advice.

- is a transferable security (including those embedding derivatives), money market instruments or a unit of a collective investment undertaking;
- has not been provided as collateral, where control has not been transferred to the collateral-taker; and
- is registered or held in an account directly or indirectly in the name of the depositary.²⁰³

7.16 ‘Other assets’ would include, for example, derivatives, cash deposits and investment in privately held companies and interests in partnerships. For these assets, a depositary will not be required to hold title to the assets, but will be required to verify the right of ownership of the AIF.

7.17 We acknowledge that it may be difficult for depositaries to verify conclusively that the AIF has ownership of some types of assets that cannot be held in custody (e.g. where there is impaired title to physical assets). We continue to consider that it is appropriate for the depositary to exercise its professional judgement to assess what information is required in different circumstances.

Q42: What other categories of assets would not be required to be registered by the depositary in a segregated account?

Q43: Do you agree that no additional guidance is required for the verification of assets, and it is appropriate for the depositary to exercise its professional judgement to assess what information is required in different circumstances? If not, what assets do you consider need further guidance and what steps do you consider relevant to verify ownership of those assets?

Oversight of certain operational functions

7.18 ESMA’s advice specifies the oversight requirements for a depositary. This includes its responsibilities in relation to the valuation of shares/units in calculating an AIF’s net asset value. In fulfilling its duty in relation to the valuation of shares/units, the depositary is expected to ensure that there are appropriate procedures in place to perform the valuation of units or shares of the AIF in accordance with national law, the AIF rules or instruments of incorporation, and the procedures specified in the Directive. The depositary should be expected to take all reasonable steps to ensure that the valuation procedures are appropriate for the nature, scale and complexity of the AIF and that the valuation provided to investors is appropriate.

203 Box 79-81 ESMA advice.

Requirements for UK AIFM marketing non-EU AIF

- 7.19** A non-EU AIF marketed in the UK and managed by a UK AIFM is not required under Article 36 to have a single depositary to carry on all three of the primary depositary functions. In this instance, the requirement for a single depositary is removed but the AIFM must ensure that one or more persons are appointed to carry on these functions.
- 7.20** The entities that might offer these services are likely to be custodians, trustees, prime brokers, fund administrators and transfer agents. These persons may be established in or outside of the UK. The AIFM is prohibited from directly offering these services, but the Directive does not explain whether these functions could be offered by a sister company within the AIFM's group. So as to reduce investor risks and any conflicts of interest, we will need to consider what requirements, if any, should be imposed on firms in the same group as the AIFM that offer these services.
- 7.21** A firm offering these services outside the UK will generally be subject to regulation in its local jurisdiction. If that firm was established in the UK, the determination of whether it was carrying on a regulated activity would depend on the exact nature of the activity carried on, particularly in relation to the safe-keeping of assets. The UK Authorities will need to consider what the appropriate regulatory treatment for these firms should be when they are established in the UK.

Q44: When carrying out their valuation oversight duties, how will depositaries ensure that the valuation procedures are appropriate with regard to the nature, scale and complexity of the AIF under management?

Q45: Do you consider that those entities performing the primary depositary functions should be acting independently of the AIFM and not be part of the same group as the AIFM? What are the implications of such an interpretation?

Q46: What is the appropriate regulatory treatment for firms that carry on one or more of the three primary depositary functions for non-EU AIFs? Are there industry codes or principles of best practice that these firms should adhere to?

Segregation of assets by a sub-custodian

- 7.22** Before a depositary can delegate safe-keeping to a third party it must, among other things, assess whether assets held in custody are 'insolvency-remote'. In instances where national law does not afford insolvency protection to segregated assets, the depositary should assess

what additional arrangements could be made to minimise the risk of loss and maintain an adequate level of protection. ESMA's explanatory notes to its advice²⁰⁴ suggest that some or all of the following measures could be used:

- making a disclosure to the AIF and AIFM so that this aspect of custody risk is properly taken into account in the investment decision by the AIFM;
- taking whatever measures are available in the local jurisdiction to make the assets as 'insolvency-proof' as possible based on local law advice;
- undertaking appropriate levels of ongoing monitoring to ensure that the relevant sub-custodian continues to comply with the criteria for selection set out in the depositary's initial due diligence assessment – which may involve enhanced levels of credit monitoring or of reconciliation work or other measures to identify early warning signals of potential problems;
- using buffers;
- prohibiting temporary deficits in client assets; and
- putting in place arrangements prohibiting the use of a debit balance for one client to offset a credit balance for another.

Q47: In which jurisdictions does national law not recognise the segregation of assets during insolvency proceedings? What actions are currently undertaken in such circumstances to mitigate this risk?

Q48: ESMA's advice sets out some options about how to minimise the risk of loss in such jurisdictions. Are there any other arrangements that could be used to minimise the risk of loss in such jurisdictions?

Depositary liability

7.23 The depositary's liability has been one of the most controversial elements of the Directive and it is worth remembering that ESMA's advice is only one step in the overall process for determining the final implementing measures in this area. The Directive addresses two types of loss for which the depositary may be liable: loss of financial instruments held in custody; and other losses suffered as a result of the depositary's negligent or intentional failure to properly fulfil its AIFMD obligations.

204 Box 90 (in conjunction with Box 89) ESMA advice.

- 7.24** The Directive specifies that in the event of a loss of a financial instrument held in custody, the depositary shall return a financial instrument of the identical type or the corresponding amount to the AIF or the AIFM without undue delay. ESMA's approach has been to try to strike a balance between the Directive's objectives to set a high level of investor protection and at the same time not to place inappropriate responsibility on the depositary.
- 7.25** In the first instance, there needs to be an assessment of whether a loss has occurred. ESMA's advice looks to see whether the AIF is unintentionally and permanently deprived of the right of ownership and beneficial interest of a financial instrument. For example, an intentional transfer of ownership by the AIF to a third party (e.g. a prime broker) should not be considered as a loss.
- 7.26** The next step is to consider whether the event that gave rise to the loss is one that is the result of an 'external event beyond [the depositary's] reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary'²⁰⁵, and if it is, the depositary will then not be deemed liable.
- 7.27** ESMA's advice defines an external event beyond the depositary's control as one that meets a set of accumulative conditions before a conclusion on liability can be reached.²⁰⁶ The explanatory notes to the ESMA advice seek to do this. It defines the event as being one that meets *all* of the following conditions:
- the event that led to the loss is not a result of an act or omission of the depositary or its sub-custodians to meet its obligations;
 - the event which led to the loss was beyond its reasonable control, i.e. it could not have prevented its occurrence by reasonable efforts; and
 - despite rigorous and comprehensive due diligence, it could not have prevented the loss.
- 7.28** The assessment is not simply about whether the event is external or not and then making another assessment whether it is beyond the control of the depositary. Instead the external event must meet all the above criteria before it can be deemed an event beyond the depositary's control.
- 7.29** Another aspect of this assessment is that even if the event is regarded as an external event beyond the reasonable control of the depositary, the depositary may still be liable if a judgement is made that it had not taken all reasonable efforts to avoid this risk. ESMA's advice states that a depositary would be regarded as having made reasonable efforts to avoid the loss if it can prove that:
- it had the necessary structures and expertise to identify an event it could reasonably be expected to identify, which may result in a loss of financial instruments held in custody;
 - it had reviewed whether any of these events present a significant risk of loss; and

205 Article 21(12).

206 Box 92 ESMA advice.

- where a significant risk of loss is identified, it has taken appropriate action to prevent or mitigate the loss.

Q49: What are the main changes that depositaries will have to take account of given the requirements in relation to depositary liability? What are the estimated direct and indirect costs of these changes?

8

Marketing

This section outlines the requirements under the Directive on the marketing of AIF to professional investors. We cover marketing to retail investors in Section 9.

- 8.1** One of the Directive's core objectives is to create an internal market in the EU for managing and marketing AIFs to professional investors²⁰⁷ located in the EU. Once the Directive is transposed, EU (including UK) AIFMs will be able to manage and market EU AIFs in the UK and in other EU Member States, having only been authorised in a single Member State. So, the Directive will replace the UK's existing rules on the marketing of EU AIFs managed by EU AIFMs to UK professional investors, including through national private placement (NPP).
- 8.2** AIFs are often established in jurisdictions outside the EU. This is particularly the case for hedge funds, private equity and real estate funds. Many non-EU AIFs are managed by UK AIFMs and a considerable number of these non-EU AIFs are marketed to UK professional investors.

What is marketing?

- 8.3** The commercial distribution of AIFs to professional investors occurs through a variety of different channels involving, to varying degrees, marketing and promotion by either or both AIFMs and third parties such as intermediaries and distribution or placement agents.
- 8.4** The Directive governs the distinct activity of the 'marketing' of the shares or units of an AIF to EU investors.²⁰⁸ Marketing is further described as a '*direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM*' in relation to AIF under management. One way of testing whether the distribution of an AIF is within the scope of the Directive is by determining who initiates the marketing.
- 8.5** The Directive does not, however, provide any specific details or a test to determine who has initiated an investment transaction.

²⁰⁷ In this section, references to 'investors' are to professional investors unless otherwise stated

²⁰⁸ Article 4(1)(x) specifies that the scope of marketing covered by the Directive is limited to offering or placement '*to or with investors domiciled or with a registered office in the Union*' (referred to in this paper as 'EU investors').

- 8.6 Along with other Member States, the UK has rules specifying how marketing activities should be assessed to protect retail investors, including the extent that these activities are financial promotions. Exemptions generally exist in retail marketing rules for professional investors. These rules, and any relevant industry practices for marketing AIFs in the UK, including by private placement, may need adapting for AIFMs to ensure firms comply with the Directive.

Marketing on behalf of a UK AIFM

- 8.7 Marketing in line with the Directive applies only to the offering or placement of units or shares by or on behalf of AIFMs in relation to AIFs under management.²⁰⁹ Our engagement with industry suggests that some AIFMs also distribute units or shares of AIFs managed by other UK AIFMs.
- 8.8 In some cases an AIFM may be providing MiFID investment services such as ‘investment advice’ or ‘reception and transmission of orders in relation to one or more financial instruments’²¹⁰ when distributing AIF under its management or under that of other AIFMs. In these cases, external AIFMs can perform certain activities as well as managing AIFs, as long as they meet the authorisation conditions.²¹¹
- 8.9 The Directive restricts certain other types of firm, including intermediaries which are MiFID investment firms and credit institutions, from directly or indirectly offering or placing units or shares of AIFs to EU investors. Our current view is that this may prevent MiFID investment firms and credit institutions (including those outside the EU²¹²) from offering or placing AIFs with EU investors unless the AIFM for that particular AIF is permitted to do so.

Q50: It is possible that the Commission with national regulators may consider the definition of ‘marketing’ in AIFMD transposition workshops during 2012. With this in mind, which marketing practices do you consider may be within the definition of ‘marketing’ in article 4(1)(x) of the Directive? Which practices should not be considered as ‘marketing’?

- 8.10 The current UK model of distribution of AIFs is such that in many instances third party distributors undertake this offering or placement activity either at their initiative or at that of a professional investor. These third parties often have a strong commercial link with the AIFM – either as a subsidiary or an affiliate, or may have a contractual relationship with the AIFM such as a distribution agreement. In other instances, distributing shares or units

209 Article 4(1)(x) sets out that ‘marketing’ by or on behalf of an AIFM is in relation to ‘units or shares of an AIF it manages’.

210 The FSA has set out in PERG 13.3 its interpretation of certain MiFID Investment Services and Activities including ‘investment advice’ and ‘reception and transmission of orders’.

211 Article 6(4)(b).

212 Recital 9.

in an AIF is often bundled with other services – for instance, prime brokers often provide the service of capital introduction. Alternatively, third parties, such as wealth managers or independent intermediaries, may do the distributing. In some instances these third parties will have no previous contractual or commercial relationship to the AIFM.

- 8.11** In some cases, these third party distributors undertake ‘regulated activities’ through providing these distribution services. This may include providing investment advice or the receipt and transmission of orders.
- 8.12** So it is necessary to consider in which instances offering or placement is undertaken on behalf of the AIFM and, if so, whether this may be subject to other aspects of the UK or EU regulatory framework, including MiFID. We must also consider how an activity undertaken by a third party on behalf of the AIFM which is also a MiFID investment service or activity should be treated for the purposes of the AIFMD ‘marketing’ definition.

Q51: Which material factors should also be considered when determining whether the activity of offering or placement of units or shares in an AIF falls within the Directive ‘marketing’ definition?

Q52: What else should we consider concerning the ‘on behalf of the AIFM’ element of the ‘marketing’ definition?

UK AIFM marketing a UK or EU AIF

- 8.13** Before an authorised UK AIFM can market a UK or other EU AIF in the UK or in another Member State to professional investors, it will have to notify us of its intention to do so.
- 8.14** The Directive sets out the information a UK AIFM must give us if it intends to market in the UK²¹³ and that required for marketing in another Member State.²¹⁴ This includes matters such as:
- the identity of each AIF the AIFM intends to market;
 - the AIF’s rules or instruments of incorporation;
 - the identity of the AIF depositary;
 - information relating to any master AIF if the AIF is established as a feeder AIF; and
 - information on the arrangements established to prevent units or shares of the AIF from being marketed to retail investors.

213 Article 31 and Annex III.

214 Article 32 and Annex IV.

- 8.15** Within 20 working days of receiving a complete notification, we must inform the AIFM, and, where relevant, the regulator of the other Member States, whether the AIFM may market the AIF. Permission to market may only be refused if the AIFM does not, or will not be able to comply with the Directive.²¹⁵
- 8.16** Once it receives the notification the AIFM may begin marketing. Arrangements made for the marketing of AIF in other Member States and, where relevant, arrangements established to prevent units and shares of the AIF from being marketed to retail investors will be subject to the requirements of the other Member State.²¹⁶

Private placement

- 8.17** For an initial period following the transposition of AIFMD, the marketing of non-EU AIF managed by EU AIFM, and EU and non-EU AIF managed by non-EU AIFM to investors, will continue to be permitted on a national basis (under what is commonly known as ‘private placement’). This is at the discretion of the UK Authorities and subject to compliance with certain conditions.
- 8.18** The Treasury has provisionally indicated its intention to continue to permit the marketing of non-EU AIF managed by EU AIFM, and EU and non-EU AIF managed by non-EU AIFM, to UK professional investors, subject to compliance with the minimum requirements specified in the Directive. In many, if not all, cases this will mean that, subject to these additional requirements, the private placement of non-EU AIF and EU AIF managed by non-EU AIFM in the UK, will continue.
- 8.19** The requirements applicable to an AIFM seeking to market non-EU AIF under its management to UK professional investors differ depending on the location of the AIFM. In the case of an authorised UK AIFM, the Directive requires the AIFM to comply with all AIFMD requirements except certain of those requirements which apply to depositaries.²¹⁷ In the case of a non-EU AIFM, the Directive requires compliance with the transparency requirements.²¹⁸ In both cases certain pre-requisites apply including supervisory cooperation arrangements between the regulators of the non-EU jurisdiction and the FSA.
- 8.20** The UK Authorities will need to consider how most appropriately to integrate into the current regulatory and legislative framework those Directive requirements which apply to the marketing of non-EU AIF to UK professional investors. This is likely, for example, to

215 Articles 31(3), 32(3).

216 Article 32(5).

217 Article 36 sets out the minimum requirements that apply to UK AIFM managing and marketing non-EU AIF to UK professional investors, including the requirement to ensure that one or more entities are appointed to perform the depositary functions.

218 Article 42 which provides that non-EU AIFMs operating under NPP must comply with the Directive’s transparency requirements (articles 22-24) and, where applicable articles 26-30 where the AIFs being marketed are within scope of article 26(1) – i.e. the private equity provisions.

require amendments to our existing financial promotions regime.²¹⁹ Furthermore, we will need to consider how non-EU AIFMs prove they are complying with the Directive's minimum requirements, particularly the transparency requirements.

- 8.21** Evidence of compliance by an AIFM of the requirements of the Directive may be relevant to those MiFID investment firms and credit institutions seeking to offer or place units or shares of AIFs with UK professional investors. This is because these firms and institutions are only able to directly or indirectly market units or shares of AIFs to the extent that this complies with the Directive (i.e., by or on behalf of the AIFM of a given AIF). As such these firms and institutions may require some form of assurance that the AIF units or shares may permissibly be marketed under the Directive.
- 8.22** One option for these firms and institutions may be to rely on the AIFM stating – in written attestation or some other form – that it complies with the relevant Directive requirements. A UK AIFM managing a non-EU AIF would be subject to either authorisation or registration with the FSA. However, a non-EU AIFM marketing an EU AIF or a non-EU AIF to UK professional investors would not, as a minimum, be subject to either FSA authorisation or registration; it would only have to report certain information to us periodically. As ESMA has proposed, this information would include the AIFM's identity and that of the AIF under its management.²²⁰
- 8.23** The above case would, however, not necessarily prove ongoing compliance of the AIFM with the applicable Directive requirements. So this may not be enough to assure a firm or institution intending to market AIFs managed by that AIFM to UK professional investors.
- 8.24** We will include on our public register UK AIFMs which we have registered or authorised.²²¹ We are considering the merits of also including, on a separate list, those non-EU AIFMs from which we have received notification of the marketing of AIFs to UK professional investors.²²² One of the purposes of such a list of what could be termed 'notified AIFM' would be to give intermediaries and investors an easily accessible list of non-EU AIFMs marketing AIFs to UK professional investors.
- 8.25** However, maintaining such a list presents challenges. We need to consider how entry to and exit from this list would operate – e.g. whether an AIFM on this list could submit a notification that it has stopped marketing. We would also need to consider what the inclusion of a non-EU AIFM on the list would signify to interested parties such as investors or consumers more generally. This would include any signal in relation to what would be a publicly acknowledged distinction between our role in relation to fully authorised UK AIFMs and that in relation to non-EU AIFMs on the list.

219 The regulatory framework applicable to financial promotions is summarised on the FSA's website (available from www.fsa.gov.uk/Pages/Doing/Regulated/Promo/regime/framework/index.shtml)

220 Box 110 ESMA advice.

221 The FSA Register contains details of all the firms, individuals and other bodies regulated by the FSA (available from www.fsa.gov.uk/Pages/register/index.shtml)

222 Note that article 42 refers to 'AIFs' which includes both EU and non-EU AIFs.

Q53: Should we create a distinct register or list for those non-EU AIFMs from whom we have received a notification of intention to market an AIF in the UK through national private placement?

Public offers of listed AIFs

8.26 As noted in Section 9 under ‘Listed AIFs’, some AIFMs will be managing and/or marketing listed AIFs. So it is important to draw a distinction between listing (‘admission to trading’) and marketing. Listing in this instance means that the shares have been admitted to an official list (‘admission to trading’ means that the shares have been admitted to trading on a regulated market). On the other hand, marketing in relation to listed AIFs under AIFMD is the direct or indirect offering or placement, at the initiative of the AIFM or on behalf of the AIFM, of the shares (or units) that have been, or will be, listed (or traded).

8.27 Our discussions with practitioners suggest that in many instances listed shares are normally marketed as well by virtue of the public offer that is made under a prospectus drawn up and published in line with the requirements of the Prospectus Directive.²²³ This is not necessarily the case but in instances where an offer has been made, it appears that the AIFM of the listed AIF will be required to comply with the relevant provisions in AIFMD. It is less clear how the activity of marketing under the terms of AIFMD applies in the context of existing AIFs which have previously been subject to a public offer.

Q54: Do you agree that those listed AIFs marketed by virtue of a public offer are undertaking the activity of ‘marketing’ as defined in the Directive and are therefore subject to the relevant requirements?

²²³ Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

9

Categories of AIF and specialised regimes

This sections covers special types of AIF which are subject to our domestic rules and to which additional considerations may apply, for example, corporate AIF subject to our Listing Rules (listed AIF), retail AIFs, Qualified Investor Schemes, and charity pooled investment funds.

Listed AIF

- 9.1 Most, if not all, listed²²⁴ closed-ended investment funds will be AIFs once the Directive is implemented (referred to hereafter as ‘listed AIF’). This section considers how the existing listing regime might be adapted.

Official listing

- 9.2 Listing is an accreditation signifying adherence to the range of requirements relating to corporate matters addressed in the UK listing regime. The regime has developed significantly over the last decade, mainly in response to the implementation of the EU’s Financial Services Action Plan (FSAP) which was aimed at creating a single EU capital market.
- 9.3 In the UK, those FSAP Directives relating to primary markets regulation²²⁵ were implemented through the creation of the Prospectus Rules and Disclosure and Transparency Rules. However, the FSAP Directives were principally focused on corporate transparency and did not address other areas of primary markets regulation.
- 9.4 In the UK there was demand from stakeholders to retain much established UK corporate practice, which had to be balanced against concerns that business would be driven to other

224 We use the term ‘listed’ to mean being admitted to the Official List of the UK Listing Authority.

225 ‘Primary markets’ refers to the relationship between bodies that issues securities and the investors that hold them. The FSAP directives which addressed primary markets regulation were the Transparency Directive, the Prospectus Directive and parts of the Market Abuse Directive.

centres within the single market if we imposed additional requirements above directive minimum level. After wide consultation, we chose to retain significant portions of UK corporate practice in the form of a new shorter and modernised rulebook, the FSA Listing Rules.²²⁶

- 9.5 We now have (with the exception of investment funds) two forms of accreditation within the UK listing regime:
- ‘Standard listing’ which denotes a requirement to adhere to broadly those obligations imposed by EU primary markets directives, comprising of mainly transparency requirements; and
 - ‘Premium listing’, in addition to the requirements applicable under standard listing, applies UK specific obligations principally relating to due diligence, governance and shareholder rights (e.g. pre-emption rights, greater shareholder engagement with management, one share-one vote and so forth).
- 9.6 This arrangement aims to reconcile the desire to retain high standards of corporate conduct and practice while remaining competitive in a multi-jurisdictional single market. In the case of a premium listing, the requirements reflect a set of UK assumptions on corporate practice and governance that are not necessarily shared by investors in other jurisdictions. However, it commands the confidence of investors, which is in turn attractive to issuers.
- 9.7 As a result we believe retaining the requirements now organised under the heading of premium listing has contributed to maintaining London’s position as a global finance raising centre. At the same time, the availability of standard listing to foreign and domestic companies alike ensures fair access to the main UK capital markets for companies with a broader range of governance practices.

The approach to investment funds in the UK listing regime

- 9.8 Within premium listing is a sub-category of the regime which addresses the specific governance requirements of closed-ended investment funds. This is the only listing route available for such funds: standard listing of investment funds is not allowed. Although an exceptional case, this approach is in line with the views of stakeholders that were clearly expressed during our last major consultation exercise on listed investment funds.²²⁷
- 9.9 In particular, stakeholders noted that listing on a directive-minimum basis should not be permitted for investment funds given that the relevant EU directives did not at that time specifically address investment funds in any particular detail and as such did not provide appropriate levels of protection for investors in funds.
- 9.10 One of the core tenets of the current listing regime for investment funds is the oversight exercised by the board of directors. Like any other listed company, the board is the

226 The Listing Rules sourcebook of the FSA Handbook sets out the rules that are applicable to listed companies (available from <http://fsahandbook.info/FSA/html/handbook/LR>)

227 Investment Entities Listing Review (available from www.fsa.gov.uk/pages/Library/Policy/CP/2007/07_12.shtml)

governing body of the fund and accountable to shareholders. However, most listed investment funds delegate portfolio management to a third-party asset manager which, in very many cases, will have been the original promoter of the fund.

- 9.11 The performance of the portfolio manager is therefore crucial to the overall success of the fund. As a result there is a requirement in the listing rules (a response to the ‘Splits’ crisis nearly a decade ago²²⁸) that most directors of the fund must be independent from the third party portfolio manager. Since that time in our capacity as UK Listing Authority, we have placed significant emphasis on the ability of the board to deliver robust oversight for and on behalf of shareholders in particular over any external portfolio manager. We believe that these arrangements have delivered high standards of governance and investor protection in the listed investment funds sphere.

Application of the AIFMD to listed AIF

- 9.12 The Directive²²⁹ determines that an AIFM must either be an external manager or the AIF itself. Most listed AIF have contractually appointed external portfolio managers who could potentially be the AIFM when the Directive is implemented. However, as noted above our key regulatory strategy for the sector has been an emphasis on the role of the board of directors of a listed fund, in particular in respect of the need for there to be oversight over any portfolio manager.
- 9.13 Some of the obligations the Directive places on the AIFM are oversight responsibilities including:
- establishing adequate risk management systems (article 15(2));
 - setting a maximum level of leverage (article 15(4)); and
 - making certain appointments, including a depository (article 21) and, in some circumstances, an external valuer (article 19).
- 9.14 We would attribute some of these responsibilities to the governing body in a listed fund. As such we are considering the merits of introducing a requirement into Chapter 15 of our Listing Rules to set out that, in the case of a premium listed closed-ended investment fund, the board of directors of an AIF must be able to exercise ultimate and unfettered oversight over certain matters. In this regard it would appear relevant to include matters such as the supervision of delegated tasks, such as the delegation of portfolio management to a MiFID

228 The FSA conducted an investigation into the activities of certain fund managers and brokers within the split capital investment trust sector between September 2000 and February 2002. Several key events contributed to the start of the collapse of a number of splits; the collapse of the value of technology stocks, a marked downturn in the FTSE 100 and a global fall in the value of shares following the events of September 11 in the United States. However, the impact of these events on the splits sector was further affected by the existence of financial gearing and the level of cross-holdings within the sector. The findings of the FSA investigation identified a number of areas for improvement, including, corporate governance, investor disclosure and management of conflicts of interest (see www.fsa.gov.uk/Pages/Library/Communication/PR/2004/114.shtml).

229 Article 5.

investment firm, and the implementation of the general investment policy and investment strategies of the AIF.²³⁰

Possible amendments to the listed investment fund regime

- 9.15** As we note above, the listing regime is concerned with the governance of listed companies. Given the importance of the role attached to the board of directors and the potential for conflict with the role of the AIFM, there would appear to be a merit in limiting the ability of an AIF to be premium listed to only those which are internally managed (i.e. where the AIF itself is authorised as an AIFM).
- 9.16** The consequence of the change, should we proceed with it, is that in order to be premium listed, the AIF would be required to be authorised itself under Article 5(1)(b). This change would not prevent the board of directors of the AIF delegating some or all of the management of the portfolio to a third party investment manager, as most do now. Nor do we believe that it would necessarily prevent the delegation of the *operation* of risk management systems by the board of the AIF, providing of course the AIF's responsibilities under Article 15 are met and, in particular, the operation of risk management systems is kept 'functionally and hierarchically separate' from portfolio management. Additionally, Article 20 offers scope to delegate other operational matters to a contractor subject to the guiding principle that the AIFM must not become a 'letter box entity'. So we do not believe this means that listed AIFs will necessarily need to build a completely new compliance infrastructure separate from that of their portfolio manager.
- 9.17** We see the benefits of stipulating that the investment fund itself should hold the AIFM permission as ensuring that the regime for premium listed funds post-AIFMD implementation continues to adhere to UK principles of governance. We believe that in this context the governance model our proposal would support – an AIF contracting in portfolio management services from a MiFID-regulated portfolio manager – is optimal from the point of view of governance and investor protection for listed closed-ended funds.
- 9.18** Balanced against this, the principal downside of the proposal (on which we would welcome comment) is that it may be said to restrict legitimate choice. This is because we currently do not permit standard listing of investment funds. So there is the possibility that an investment fund which wishes to adopt arrangements which comply fully with the Directive, but which reflect the different view on the lines of accountability and governance reflected in the premium listing regime would be denied any form of official listing accreditation in the UK.²³¹

²³⁰ ESMA has provided advice to the Commission that a number of these matters are relevant to ensure the AIFM does not become a letter-box entity and as such can no longer be considered to be the manager of the AIF (Box 74 ESMA advice).

²³¹ However, such funds might still be able to access UK stock markets, for example the London Stock Exchange's SFM and the AIM markets depending on the approach those markets take once the Directive is implemented.

Q55: Do you agree there are potential conflicts of interest between the role of the board in the context of the UK corporate model and the role of the AIFM? If so, which conflicts do you foresee?

Q56: Do you agree we should develop proposals to ensure that a premium listed fund must itself hold the AIFM permission envisaged under the Directive?

Application to non-EU AIF

- 9.19** A number of listed closed-ended investment funds which the Directive deems as AIFs are established outside the EU. The AIFM must comply with certain transparency requirements if it is either internally managed or managed by an AIFM established outside the EU (which will be the case in most if not all cases), to the extent that the AIFM is marketing the units or shares of the AIF to professional investors, or as relevant retail investors (see also Section 6 on ‘Transparency’). But the Directive will not require it to be authorised.
- 9.20** Discussions with practitioners suggest those listed AIF established outside the EU are very similar to those AIFs established in the UK. In recent years it has been our general policy within the wider UK listing regime to seek to ensure a level playing-field between these UK and non-UK listed issuers to the extent possible. This has been on the basis that we think such a policy is clearer for investors and fairer for issuers. The Directive provides a further opportunity to examine this analysis, so we welcome comments on whether any adaptation to the listing regime occasioned by implementation of the Directive should seek to impose similar requirements regardless of the place of establishment.

Q57: Should the listing regime, as far as possible, treat off-shore and other non-EU AIFs the same as EU AIFs?

Retail AIFs

- 9.21** The Directive is predominantly aimed at AIFs that are marketed solely to professional investors. Investment funds which require authorisation under the UCITS Directive fall outside the scope of Directive.
- 9.22** The Directive permits the UK Authorities to allow AIFMs to market AIFs to UK retail investors²³² and to impose stricter requirements than those applicable to AIFs marketed to

232 Article 43(1) permits that ‘Member States may allow AIFMs to market to retail investors in their territory units or shares of AIFs they manage...’

professional investors.²³³ The UK currently maintains a domestic-authorized investment fund regime for sale to retail investors (NURS regime) which operates alongside the UCITS regime.²³⁴ NURS are authorized by us and can, subject to certain conditions, invest in certain assets not permitted under UCITS (e.g. investment in physical real estate²³⁵).

- 9.23** Our provisional analysis is that most, if not all, existing NURS will be categorized as AIFs. As such these funds will be required to have an AIFM which complies with the requirements of the Directive.
- 9.24** Some of the Directive requirements are more detailed than the NURS rules, for example the valuation rules (see Section 5). In other areas, such as investor disclosure requirements, the NURS rules contain more detailed requirements than the Directive. However, one of the most significant additional requirements we impose on NURS is the requirement to be authorized and comply with rules governing various aspects of the operation of the NURS including its investment and borrowing powers.²³⁶

Q58: What changes to the NURS rules in the COLL sourcebook are necessary to ensure compatibility with the Directive and provide an appropriate degree of protection for retail investors?

- 9.25** Some funds may deem themselves to be internally managed under the Directive. We will need to consider our approach to authorizing NURS, including how we apply APER to directors of internally managed NURS, for instance.
- 9.26** As the Directive will regulate managers of NURS, we are considering how to change our existing rules governing NURS managers to ensure compatibility with the Directive and avoid any potential conflicts between our rules and the Directive's requirements. We will need to ensure that an appropriate degree of protection for retail investors is maintained.

Q59: What changes should we consider making to the authorization regime for NURS, including the application of the approved persons regime to internally managed NURS that become AIFs?

- 9.27** The Directive contains a number of requirements which are common to the UCITS Directive (and to some extent MiFID). These rules include elements of organisational requirements and operating conditions, and the duties of a depositary to oversee certain aspects of the management of an AIF. The Commission has consulted on these requirements

233 Article 43(1) permits that 'Member States may impose stricter requirements on the AIFM or the AIF than the requirements applicable to the AIFs marketed to professional investors in their territory in accordance with this Directive.'

234 The COLL sourcebook sets out the rules for Non-UCITS Retail Schemes (available from <http://fsahandbook.info/FSA/html/handbook/COLL>)

235 Commission Directive 2007/16/EC specifies the 'eligible assets' in which UCITS are able to invest (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:079:0011:0019:EN:PDF>)

236 Chapter 5 of COLL sets out the investment and borrowing powers for authorized investment funds (available from <http://fsahandbook.info/FSA/html/handbook/COLL/5>)

potentially reading across some of the AIFMD provisions to UCITS, including the requirements applicable to depositaries and remuneration.²³⁷

- 9.28** We have, over time, developed more detailed requirements for existing authorised funds including UCITS and NURS, based on national law and principles embodied in the UCITS Directive. This has included, for example, the duties of a depositary to oversee certain aspects of the management of a fund.²³⁸
- 9.29** In 2012 the Commission will adopt implementing measures specifying the more detailed requirements underpinning the Directive. Considering that ESMA's advice to the Commission proposes alignment with the UCITS Directive requirements where there is commonality, we may need to consider applying a set of core rules to both NURS and UCITS. Such an approach may make compliance easier for firms managing and marketing both types of fund. However, this may impose additional requirements on firms managing only UCITS if the final implementing measures for the Directive go further than those currently in our Handbook.

Q60: Should we consider aligning the requirements for UCITS management companies and AIFMs where the Directive and the UCITS Directive contain common requirements?

- 9.30** The Directive will permit an EU AIFM to market an EU AIF to UK professional investors, as long as it notifies its regulator. As noted previously in this section, the Directive permits the UK authorities to allow AIFMs to market AIFs to UK retail investors and to impose stricter or additional requirements to those applicable to AIFs marketed to professional investors.²³⁹ If the UK Authorities allow the marketing of AIF to retail investors, non-UK AIFM must also be allowed to market on a cross-border basis²⁴⁰ under the same rules.²⁴¹
- 9.31** The UK Authorities will need to consider under what conditions an AIFM would be entitled to market to UK retail investors. For example, should we require a notification of their intent to market to UK retail investors, and what would this notification entail? Should we assess the compliance of EU AIFs to ensure that they comply with our requirements – and if so, how? Should there be a register of these EU AIFs or EU AIFMs, and would investors appreciate the difference between registration and authorisation (some of these issues are also discussed in Section 8 (Marketing)).

Q61: What should we consider in permitting EU AIFs to be marketed to UK retail investors?

237 http://ec.europa.eu/internal_market/consultations/2010/ucits_en.htm

238 Article 22(3) of the UCITS Directive specifies the five 'oversight' duties of a depositary which are contained in COLL 6.6.

239 Article 43(1) permits that '*Member States may allow AIFMs to market to retail investors in their territory units or shares of AIFs they manage...*'

240 That is, other EU AIFM coming into the UK on the Directive's marketing passport.

241 Article 43(1) requires that '*Member States shall not impose stricter or additional requirements on EU AIFs established in another Member State and marketed on a cross-border basis than on AIFs marketed domestically.*'

Recognised AIFs

- 9.32** The current UK legislative framework for CIS permits the ‘recognition’ of certain third country non-UCITS schemes for promotion to UK retail investors, as long as they comply with certain conditions. This recognition can either be granted to those classes of schemes established in non-EEA designated countries or territories²⁴² or on an individual basis.²⁴³
- 9.33** Under the current recognition regime, regulators assess whether the levels of investor protection in the countries or territories to be designated are equivalent. The UK Authorities will need to consider whether it is possible and/or desirable to maintain the current FSMA regimes and their purpose and compatibility with the Directive. In addition, since this regime currently only applies to CIS, we must consider whether it applies to those AIFs outside the current CIS definition.

Q62: What changes, if any, are required to the FSMA regime for recognised schemes as part of the transposition of the Directive?

Internally managed AIFs

- 9.34** Authorised investment funds established in the UK have historically appointed a third-party ‘manager’ to undertake certain activities in relation to the management of the fund and, in some cases, its operation and administration.²⁴⁴ As such most, if not all, investment funds established in the UK and authorised by us have traditionally been considered as externally managed.
- 9.35** The Directive recognises that responsibility for managing AIFs can rest with either the fund itself (i.e. internally managed) or an external party.²⁴⁵ An internally managed AIF²⁴⁶ will itself be the AIFM and, as such, subject to the Directive. Certain requirements of the Directive apply exclusively to internally managed AIFs – e.g. the requirement to hold initial capital of at least €300,000²⁴⁷ (see Section 4).
- 9.36** Our discussions with stakeholders suggest that investment funds structured as corporate vehicles, including OEICs, are likely to be deemed capable of being internally managed. In the instance where the authorised investment fund is an OEIC, the OEIC itself would have to seek authorisation as an AIFM as well as authorisation as an AIF.

242 s270 of FSMA sets out the provisions regarding schemes authorised in designated countries or territories (available from www.legislation.gov.uk/ukpga/2000/8/section/270)

243 s272 of FSMA sets out the provisions regarding individually recognised overseas schemes (available from www.legislation.gov.uk/ukpga/2000/8/section/272)

244 The Glossary to the FSA handbook defines the manager in relation to Authorised Unit Trusts (AUTs) and Open Ended Investment Companies (OEICs) (available from <http://fsahandbook.info/FSA/glossary-html/handbook/Glossary/M?definition=G681>)

245 Article 5 and Recital 20 outline the instances and conditions under which an AIF may be ‘internally managed’ or ‘externally managed’.

246 The term ‘internally managed AIF’ in this paper refers to an AIF where the legal form of the AIF permits an internal management and where the AIF’s governing body chooses not to appoint an external AIF in accordance with Article 5(1)(b).

247 Article 9(1) specifies the initial capital requirements for internally managed AIF.

- 9.37** Investment funds structured as unit trusts or contractual funds would more likely be considered as externally managed. It would appear possible, however, for certain legal forms of investment fund to be either internally or externally managed.
- 9.38** A number of AIFs are structured as partnerships either with their own legal personality or, more predominantly, without legal personality. It remains unclear whether these investment funds will be deemed internally or externally managed, including, for instance, in the case of an English Limited Partnership where the general partner may be the AIFM. In this respect, it is notable that the Directive requires that the AIFM is a 'legal person' which is either registered or authorised by us.²⁴⁸
- 9.39** The UK Authorities will need to review the OEIC regulations²⁴⁹ and our rules applicable to authorised investment funds to ensure that they are compatible with the Directive's requirements for internally managed AIFs. They will also need to consider the changes necessary to ensure efficient authorisation of an AIFM where the AIF under management takes the form of a partnership.

Q63: Which types of UK AIF are most likely to deem themselves as internally managed?

Q64: Which aspects of the current UK regulatory framework might present particular challenges for internally managed AIFs?
(See also Q23)

Q65: What changes, if any, are necessary to the process or requirements for FSA authorisation for AIFMs in cases where the AIF under management takes the form of a partnership?

Qualified Investor Schemes

- 9.40** QIS are UK-authorised open-ended investment funds primarily aimed at professional investors.²⁵⁰ It is likely that most, if not all, QIS will need to become AIFs, so we will need to ensure that our current rules applicable to the managers of QIS remain compatible with the Directive. The Directive provides an opportunity to re-examine the regulatory regime

248 Article 4(1)(b) defines AIFMs as 'legal persons whose regular business is managing one or more AIFs'.

249 The OEIC Regulations including section 15(6) and (7) specify the requirements for directors to be appointed for an OEIC (available from www.legislation.gov.uk/ukxi/2001/1228/pdfs/ukxi_20011228_en.pdf)

250 COLL 8.1.2 specifies that qualified investor schemes are intended for investors that are, in general, prepared to accept a higher degree of risk in their investments or have a higher degree of experience and expertise than investors in retail schemes. (available from <http://fsahandbook.info/FSA/html/handbook/COLL/8/1>)

applicable to these funds, particularly as the number of QIS remain limited (17 at 5 January 2012).

- 9.41** Some aspects of the Directive, for example the pre-sale investor disclosure requirements and the provision of annual reports to investors, are broadly aligned to the existing QIS rules. In some areas, however, such as investment and borrowing powers, the existing QIS rules go beyond requirements in the Directive. In other areas, for instance in relation to valuation, the Directive contains more detailed provisions.²⁵¹
- 9.42** Given the limited number of QIS currently in existence and the application of the Directive, we will need to consider the overall regulatory regime applicable to QIS. Discussions with industry suggest that there are a number of important factors including tax and restrictions in some investment mandates. One option might be to remove most or all of our rules which apply to a QIS manager which go beyond the requirements of the Directive. This would mean that a QIS manager would only comply with the Directive requirements. We would then need to consider what benefits authorisation of the QIS provides.

Q66: Is there still strong demand for an authorised investment funds regime only for professional investors (i.e. our QIS regime)? What changes should we make to the existing QIS regime as part of the implementation of the Directive?

Charity pooled investment funds

- 9.43** Charity pooled investment funds (CPIF) provide a number of specific vehicles into which charities and other institutions can invest. Many CPIF are subject to regulation by the Charity Commission under domestic rules similar to those applicable under our domestic authorised investment funds regime.
- 9.44** It is likely that many, if not all, CPIF will be AIFs. The managers of CPIF will be required to become AIFMs and subject to the requirements of the Directive. The UK Authorities have previously consulted on developing a bespoke CPIF regime, open only to charity investors. This consultation included bringing the regulation of CPIF more fully into the FSA's regulatory remit while preserving the existing UK tax regime.²⁵²
- 9.45** The UK Authorities will need to consider the responses to the consultation against the requirements of the Directive. We will also consider how the marketing requirements under the Directive operate, given that a number of charities may be classed as retail rather than professional investors. Our initial discussions with industry suggest that some of the Directive's requirements may create particular challenges for certain types of CPIF.

²⁵¹ Article 19.

²⁵² *Charity pooled funds consultation*, July 2009, (available from www.hm-treasury.gov.uk/d/consult_charitypooledfunds300709.pdf)

Q67: Which aspects of the Directive could create particular challenges for those charity pooled investment funds that will fall within the definition of an AIF?

Unregulated AIF and CIS

- 9.46** The Directive will bring into scope for the first time managers of investment funds that do not currently fall within the definition of a CIS²⁵³ but will fall within the definition of an AIF under the Directive²⁵⁴ (for example, a listed investment company – see the section on ‘Listed AIF’).
- 9.47** In addition, managers of unregulated collective investment schemes (UCIS) might come within the scope of the Directive. However, since these managers are already carrying on the regulated activity of operating a UCIS, they will already be authorised by us.²⁵⁵
- 9.48** We are considering what the appropriate regulatory treatment is for those vehicles or schemes currently excluded from the CIS definition but which fall within the Directive definition of an AIF. This may be particularly relevant to certain bodies corporate, such as a listed investment company, that are excluded from the CIS definition²⁵⁶ but which could still fall within the definition of AIF and do not benefit from any of the exclusion of scope or exemption provisions including those relating to ‘holding companies’ as defined in the Directive (see Section 3).²⁵⁷

Q68: Which types of investment fund currently excluded from the UK definition of a collective investment scheme are likely to come within the definition of an AIF?

- 9.49** As previously noted, the Directive deals predominantly with the marketing of AIFs to professional investors but permits the UK Authorities to allow the marketing of AIFs to UK retail investors with the safeguard of stricter requirements.
- 9.50** We have recently expressed concerns about the promotion and sale of UCIS to UK retail investors.²⁵⁸ As such, we will need to consider the current prohibitions on the retail

253 A CIS is defined in Section 235 of the Financial Services and Markets (FSMA) Act 2000 (as amended) (available from www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga_20000008_en.pdf) and the FSMA 2000 (Collective Investment Schemes) Order 2001 (as amended) (available from www.legislation.gov.uk/uksi/2001/1062/pdfs/uksi_20011062_en.pdf).

254 Article 4(1)(a) defines ‘AIFs’.

255 Section 51 of RAO defines the activity of establishing, operating or winding up a collective investment scheme. (available from www.legislation.gov.uk/uksi/2001/544/pdfs/uksi_20010544_en.pdf)

256 Section 21 of the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 specifies the instances where bodies corporate do not amount to collective investment schemes (available from www.legislation.gov.uk/uksi/2001/1062/pdfs/uksi_20011062_en.pdf)

257 Article 2(3)(a) read with article 4(1)(o)(i) and (ii).

258 www.fsa.gov.uk/Pages/consumerinformation/product_news/saving_investments/ucis/index.shtml

marketing of unregulated AIFs and more broadly the circumstances in which these funds are sold to retail investors.

Q69: What other changes should we consider making to rules on the marketing and distribution of unregulated AIFs to retail investors?

Annex 1

List of DP questions

- Q1:** What other criteria could be used to distinguish a JV from an AIF and, in particular, a JV where not all participants are involved in its day-to-day management?
- Q2:** How should we look to characterise the ‘family relationship’ between investors?
- Q3:** Are there other features of a family investment vehicle that might distinguish it from an AIF?
- Q4:** (a) Which aspects of the Directive should we consider applying to small UK AIFMs?
(b) In particular, which aspects of the Directive should we consider applying given that a distinction may be drawn between types of AIF or AIFM?
- Q5:** What factors should be considered when assessing the fair treatment of consumers, especially where some investors in a fund have received preferential treatment?
- Q6:** Do you agree that fair treatment of retail consumers should equally apply to professional investors?

- Q7:** What organisational arrangements might raise particular issues for UK AIFMs? Do these requirements pose particular difficulties for private equity firms in the light of their distinct business model?
- Q8:** What are the major challenges in the development of remuneration guidelines appropriate to the structure of AIFMs?
- Q9:** What options could be considered for implementing the remuneration requirements of the Directive that would achieve fair and appropriate alignment with the existing Remuneration Code?
- Q10:** What are the practical issues for potential AIFMs in establishing a remuneration committee?
- Q11:** What criteria should be used to determine whether it is disproportionate to require an AIFM to have a separate compliance function? What criteria should be used to determine whether it is disproportionate for an AIFM to establish an audit function?
- Q12:** As organisational requirements are also covered by other Directives relevant to fund management, such as MiFID and the UCITS Directive, will any potential overlap with these Directives create any problems?
- Q13:** In what circumstances would you be unable to meet the requirement to have functional and hierarchical separation of your risk management function and would need to rely on having appropriate safeguards?
- Q14:** For what reasons might the use of a qualitative, not a quantitative, risk limit, be in the interests of AIF investors?

- Q15:** What constitutes a 'material change' to the maximum level of leverage set for an AIF may vary according to changes in the market. What factors should we take into account in determining what constitutes a material change?
- Q16:** A material change to the maximum leverage limit set by an AIFM must be disclosed to investors and to us. Operationally, what will be the best way to report this to us?
- Q17:** What are the particular challenges for your firm as a result of the delegation requirements? How will this affect existing operational structures?
- Q18:** Do you have any comments on our analysis as to how we expect the capital and PII requirements to apply to the different types of firm acting as managers of AIFs?
- Q19:** Do you agree that it would be appropriate to set out the requirements for UCITS firms and UCITS AIFM firms in IPRU (INV)?
- Q20:** Do you expect to want to use a guarantee to meet part of the additional own funds requirement?
- Q21:** Do you have any comments on how AIFMs might comply with any PII requirements adopted in Commission implementing measures based on the ESMA advice?
- Q22:** To what extent do you expect to use PII as part of the required financial resources to cover professional negligence risks?
- Q23:** Do you have any comments on the most appropriate approach to determine the prudential requirements for internally managed AIFs?

- Q24:** Do you have views on the intended meaning of CAD-defined terms and our approach to incorporating them in the rules for AIFMs?
- Q25:** What are the most significant considerations that we should take into account when assessing the need to require AIFMs to have their valuation procedures and/or valuations verified by an external valuer or auditor?
- Q26:** What professional guarantees by an external valuer would be sufficient to show that it can meet the requirements of the Directive?
- Q27:** How should the NAV calculation requirement apply to an AIF that does not use the 'share/unit' concept?
- Q28:** Are there any particular challenges for your firm as a result of the liquidity requirements?
- Q29:** What criteria should we take into account when considering whether arrangements of capital commitments might be temporary in nature?
- Q30:** In what instances do you consider that neither the Gross nor Commitment methods of leverage calculation would provide a reasonable or approximate reflection of leverage within an AIF?
- Q31:** What aspects of the proposed requirements for investment in securitisation positions present the most significant challenges and/or create the most significant degree of uncertainty for AIFMs, including in relation to the interaction with the existing requirements applicable to credit institutions and insurance undertakings?

- Q32:** Do you anticipate any particular issues or challenges arising from the grandfathering provisions for investment in securitisation positions?
- Q33:** Do you agree that our existing disclosure requirements for NURS should be maintained?
- Q34:** Subject to the minimum disclosure requirements in article 23, do you consider that our existing QIS disclosure requirements should be maintained?
- Q35:** What are the implications, if any, of the remuneration disclosure requirements for those firms already subject to the provisions of the FSA's Remuneration Code?
- Q36:** What are the implications for firms currently outside the Remuneration Code, e.g. real estate funds and private equity firms?
- Q37:** Reporting by third country AIFMs marketing AIFs in the UK will need to be captured. There is no current process for this. What do you believe would be a practical solution for this?
- Q38:** While a depositary is a feature of FSMA-authorized funds (including NURS), the requirement to ensure the appointment of a depositary for unregulated CIS represents a change for UK AIFMs. What additional costs and benefits might this change give rise to?
- Q39:** Should the capital requirements for depositaries within the third bullet of paragraph 7.3 of this DP be increased and, if so, what approach should be taken? What role could insurance have in supplementing this requirement? Where the depositary is within a group, to what extent would a parent stand behind its subsidiary in the case of a default and/or loss of assets?

- Q40:** Are there any bodies (e.g. lawyers, accountants or fund administrators) that intend to offer depositary services to the type of AIF in paragraph 7.7 of this DP? What would be an appropriate prudential regime for these types of depositary and what level of financial or professional guarantees should be given? Should we apply any other FSA requirements to these depositaries?
- Q41:** Do you agree with our view that a depositary, in having to meet its existing FSA requirements, may already be carrying on most or all of the Directive requirements in relation to monitoring cash flow? If you disagree, what costs and benefits do you consider the Directive requirements will impose?
- Q42:** What other categories of assets would not be required to be registered by the depositary in a segregated account?
- Q43:** Do you agree that no additional guidance is required for the verification of assets, and it is appropriate for the depositary to exercise its professional judgement to assess what information is required in different circumstances? If not, what assets do you consider need further guidance and what steps do you consider relevant to verify ownership of those assets?
- Q44:** When carrying out their valuation oversight duties, how will depositaries ensure that the valuation procedures are appropriate with regard to the nature, scale and complexity of the AIF under management?
- Q45:** Do you consider that those entities performing the primary depositary functions should be acting independently of the AIFM and not be part of the same group as the AIFM? What are the implications of such an interpretation?
- Q46:** What is the appropriate regulatory treatment for firms that carry on one or more of the three primary depositary functions for non-EU AIFs? Are there industry codes or principles of best practice that these firms should adhere to?

- Q47:** In which jurisdictions does national law not recognise the segregation of assets during insolvency proceedings? What actions are currently undertaken in such circumstances to mitigate this risk?
- Q48:** ESMA's advice sets out some options about how to minimise the risk of loss in such jurisdictions. Are there any other arrangements that could be used to minimise the risk of loss in such jurisdictions?
- Q49:** What are the main changes that depositaries will have to take account of given the requirements in relation to depositary liability? What are the estimated direct and indirect costs of these changes?
- Q50:** It is possible that the Commission with national regulators may consider the definition of 'marketing' in AIFMD transposition workshops during 2012. With this in mind, which marketing practices do you consider may be within the definition of 'marketing' in article 4(1)(x) of the Directive? Which practices should not be considered as 'marketing'?
- Q51:** Which material factors should also be considered when determining whether the activity of offering or placement of units or shares in an AIF falls within the Directive 'marketing' definition?
- Q52:** What else should we consider concerning the 'on behalf of the AIFM' element of the 'marketing' definition?
- Q53:** Should we create a distinct register or list for those non-EU AIFMs from whom we have received a notification of intention to market an AIF in the UK through national private placement?

- Q54:** Do you agree that those listed AIFs marketed by virtue of a public offer are undertaking the activity of 'marketing' as defined in the Directive and are therefore subject to the relevant requirements?
- Q55:** Do you agree there are potential conflicts of interest between the role of the board in the context of the UK corporate model and the role of the AIFM? If so, which conflicts do you foresee?
- Q56:** Do you agree we should develop proposals to ensure that a premium listed fund must itself hold the AIFM permission envisaged under the Directive?
- Q57:** Should the listing regime, as far as possible, treat off-shore and other non-EU AIFs the same as EU AIFs?
- Q58:** What changes to the NURS rules in the COLL sourcebook are necessary to ensure compatibility with the Directive and provide an appropriate degree of protection for retail investors?
- Q59:** What changes should we consider making to the authorisation regime for NURS, including the application of the approved persons regime to internally managed NURS that become AIFs?
- Q60:** Should we consider aligning the requirements for UCITS management companies and AIFMs where the Directive and the UCITS Directive contain common requirements?
- Q61:** What should we consider in permitting EU AIFs to be marketed to UK retail investors?
- Q62:** What changes, if any, are required to the FSMA regime for recognised schemes as part of the transposition of the Directive?

- Q63:** Which types of UK AIF are most likely to deem themselves as internally managed?
- Q64:** Which aspects of the current UK regulatory framework might present particular challenges for internally managed AIFs? (See also Q23)
- Q65:** What changes, if any, are necessary to the process or requirements for FSA authorisation for AIFMs in cases where the AIF under management takes the form of a partnership?
- Q66:** Is there still strong demand for an authorised investment funds regime only for professional investors (i.e. our QIS regime)? What changes should we make to the existing QIS regime as part of the implementation of the Directive?
- Q67:** Which aspects of the Directive could create particular challenges for those charity pooled investment funds that will fall within the definition of an AIF?
- Q68:** Which types of investment fund currently excluded from the UK definition of a collective investment scheme are likely to come within the definition of an AIF?
- Q69:** What other changes should we consider making to rules on the marketing and distribution of unregulated AIFs to retail investors?

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