

ALTERNATIVE INVESTMENT FUNDS IN EUROPE

Law and Practice

Edited by

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Danny Busch and Lodewijk van Setten

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I. Terms of Reference

1. *The extraordinary expansion of the EU regulatory framework for investment funds and the creation of a single market for non-UCITS*

A. Pre-AIFMD: UCITS, NURS, and unregulated funds

1.01 Since 1989¹ it has been possible to seek authorization as an ‘undertaking for collective investment in transferable securities’ (UCITS) for EU based, open-ended collective investment arrangements that invest in a diversified portfolio of transferable securities and seek to offer participations to the public.² Authorization of an investment fund as a UCITS will permit the offering of participations in the UCITS to the public in Member States other than the Member State under the laws of which the UCITS is organized without further authorization by the host Member State.³

1.02 The regulation of collective investment arrangements that are not UCITSs—including investment funds offered to the public in only one Member State, known as non-UCITS

¹ See Art 57(1) of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (OJ 1985 L375/3) (the original UCITS Directive).

² See Arts 1 and 3(b) of Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (OJ 2009 L302/32) (‘UCITS Directive’) (recasting Arts 1 and 2 of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities).

³ See UCITS Directive, Arts 1(6), 5(1), 91.

retail schemes or ‘NURSS’—traditionally has been left to the Member States’ national initiative. The Member States took different positions in relation to the scope of their national regulatory frameworks for investment funds and otherwise similar schemes received different regulatory treatment under the national frameworks. What was a ‘collective investment fund’ was decided by reference to different criteria and, where arrangements were caught as collective investment funds, national frameworks tended to treat the exclusions or exemptions from the offering of participations in these funds differently. Equally, ‘managing a collective investment scheme’ other than a UCITS fund was not a regulated activity in all jurisdictions.

This resulted in a diverse collection of regulatory frameworks ranging from the fairly liberal—which seek to regulate only investment funds that are offered to the public, thus leaving certain qualified investors free to invest in unregulated investment funds—to the conservative—which prohibit the offering of any unregulated investment funds in any circumstances. For instance, a closed-ended investment trust was not treated as a ‘collective investment scheme’ in the UK, but would have been an ‘investment institution’ in the Netherlands. Equally, the Netherlands and the UK exempted the offering of (foreign) funds to qualifying investors subject to certain criteria, but Italy and France offered no such exemptions for foreign funds. **1.03**

B. The AIFMD: a sweeping Directive

The implementation of the Alternative Investment Fund Managers Directive⁴ (AIFMD) has introduced maximum (sometimes permitting Member State ‘gold-plating’) harmonizing regulatory standards into the previously diverse landscape. The AIFMD brings the managing of ‘alternative investment funds’ (AIFs) from the EU, and the offering of units, shares, or other participations rights in AIFs to professional investors (ie non-retail investors) based in the EU, within the scope of pan-EU regulatory framework. **1.04**

AIFs are very broadly defined as ‘collective investment undertakings’ which are offered to ‘a number of investors’, invest the collective assets ‘in accordance with a defined investment policy’ and do not require authorization as a UCITS.⁵ The definition purposefully does not limit the catchment area.⁶ Simply put, the AIFMD captures all arrangements that have some collective investment characteristic and are not a UCITS. The definition ignores whether the arrangement is open-ended or closed-ended, what legal form it has, whether or not the participation rights are listed, and, notwithstanding the name of the Directive,⁷ what it invests in.⁸ **1.05**

⁴ 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 (OJ 2011 L174/1).

⁵ AIFMD, Art 4(a).

⁶ See AIFMD, recital (6).

⁷ The term ‘alternative investment fund’ is commonly understood to refer to funds that aim to invest in ‘alternative’ asset classes, ie asset classes such as commodities, currencies, real estate, and private equity which have return properties that are not highly correlated to the return properties of traditional asset classes such as equities and fixed income. The definition of ‘AIF’ is not limited to collective investment arrangements that invest in ‘alternative asset classes’.

⁸ See para 1.1 of the Explanatory Memorandum to the final Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009, COM(2009) 207 final.

- 1.06** The AIFMD is aimed at the managers of AIFs, referred to in the AIFMD as ‘Alternative Investment Fund Managers’ (AIFMs), rather than the AIFs they manage.⁹ AIFs may continue to be regulated and supervised at the national level. It is the AIFM’s, not the AIF’s, responsibility to ensure that the management and offering of the AIF complies with the AIFMD. The AIFMD applies to the EU or non-EU manager of an AIF regardless of whether the AIF is an EU AIF or a non-EU AIF, although non-EU AIFs may be exempted from certain provisions, particularly if the non-EU AIF is not marketed in the EU. But EU AIFMs will always need some form of authorization under the AIFMD.
- 1.07** Subject to *de minimis* and other exemptions, and an implementation period for non-EU managers and for (EU and non-EU) managers of non-EU AIFs, the AIFMD sets aside all qualified investor, private placement, or similar exclusions or exemptions that operated on the offering of funds that were not authorized to be offered to the public at national level prior to the AIFMD coming into force. Outside the limited *de minimis* exemptions, there are no options left for operators of non-UCITS investment funds to offer participations within the parameters of these types of regulatory safe havens.
- 1.08** The implementation of the AIFMD, therefore, amounts to an extraordinary expansion of the EU regulation of the management and offering of non-UCITS collective investment schemes. Had the European legislator wanted to give the Directive a more meaningful name, it should have been called the ‘Professional Investor Fund Manager Directive’ or maybe even the ‘Non-UCITS Fund Manager Directive’.

C. The creation of a single market for management and marketing of AIFs

- 1.09** One of the aims of the AIFMD is to ensure that, once fully operative, it will create a single market in which EU and non-EU AIFMs authorized by one Member State may also manage AIFs in all other Member States and market their AIFs freely to professional investors in the EEA subject to a harmonized offering regime.¹⁰
- 1.10** The AIFMD makes a distinction between authorization of EU AIFMs and authorization of non-EU AIFMs, and a further distinction between the management and marketing of EU AIFs and the management and marketing of non-EU AIFs. As a result, the regulatory framework has become complex. The table below is designed to assist in the navigation of the AIFMD maze.

	EU AIF	Non-EU AIF
EU AIFM <i>Managing</i>	<ul style="list-style-type: none"> • Art 6: authorization by home Member State to manage EU AIF established in Member State. • Art 33: subject to notification, authorized EU AIFM may manage EU AIFs established in another Member State (European passport). 	<ul style="list-style-type: none"> • Art 6: authorization by home Member State to manage non-EU AIFs, if marketed under Art 35. • Art 34: authorization by home Member State to manage non-EU AIF if it is <i>not</i> marketed in EU. Non-EU AIF must be AIFMD-compliant except Arts 21 (depository) and 22 (disclosure).

⁹ AIFMD, recital (10) notes specifically that the AIFMD does not seek to regulate AIFs per se.

¹⁰ See AIFMD, recital (4).

I. Terms of Reference

	EU AIF	Non-EU AIF
<i>Marketing to professional investors</i>	<ul style="list-style-type: none"> • Art 31: authorized EU AIFM may market (feeders into) EU AIFs in home Member State. • Art 32: subject to notification, authorized AIFM may market any EU AIF cross-border (European passport). 	<ul style="list-style-type: none"> • Art 35*: subject to notification, authorized EU AIFM may market (feeders into) non-EU AIF in home and other Member States (European passport). • Art 36***: authorized EU AIFM on a per-Member-State basis may be permitted to market (feeders into) non-EU AIFs in accordance with national regimes ('private placement'). Non-EU AIF must be AIFMD compliant except Art 21 (depository).
Non-EU AIFM	<i>Managing</i>	
	<ul style="list-style-type: none"> • Art 37*: authorization by Member State of reference to manage EU AIFs established in Member State of reference. Non-EU AIFM must comply with AIFMD, but potential non-compatibility relief per Art 37(2). • Art 41*: subject to notification, authorized non-EU AIFM may manage EU AIF established in a Member State other than the Member State of reference (European passport). 	<ul style="list-style-type: none"> • Art 37*: if non-EU AIFM manages non-EU AIFs only, but intends to market these in EU per Art 40*, the same rules apply as apply to non-EU AIFMs managing EU AIFs.
	<i>Marketing to professional investors</i>	
	<ul style="list-style-type: none"> • Art 39*: subject to notifications, authorized non-EU AIFM may market (feeders into) non-EU AIF in Member State of reference and other Member States (European passport). • Art 43*: subject to compliance with transparency requirements in Arts 22–24, and provisions of Arts 26–30, Member States may permit marketing of EU and non-EU AIFs by non-EU AIFMs in accordance with national regimes ('private placement'). 	<ul style="list-style-type: none"> • Art 40*: subject to notifications, authorized non-EU AIFM may market (feeders into) non-EU AIF in Member State of reference and other Member States (European passport). • Art 42***: same rules as apply to non-EU AIFM marketing EU AIFs.

* Article 66(3) delays implementation of Article 35 and Articles 37–41 until activated by a Commission delegated act made pursuant to Article 67(6). The delegated act must be adopted three months after the European Securities and Markets Authority (ESMA) has given positive advice pursuant to Article 67(1) about extending passporting rights for the marketing of non-EU AIFs by EU AIFMs within the meaning of Article 35 and Articles 37–41. ESMA must give advice by 22 July 2015.

** Article 66(4) provides for termination of Articles 36 and 42 by a Commission delegated act made pursuant to Article 68(6). The delegated act must be adopted three months after ESMA has given positive advice pursuant to Article 68(1) about terminating the national regimes, if any, made under Articles 36 and 42. ESMA's advice must follow three years after the 22 July 2015 advice relating to extending passporting rights for the marketing of non-EU AIFs by EU AIFMs within the meaning of Article 35 and Articles 37–41. In other words, ESMA must give termination advice by 22 July 2018.

- 1.11** Unlike the UCITS Directive, the AIFMD does not seek harmonization of the constitution and operation of the AIF. This was deemed to be ‘disproportionate’.¹¹ In other words, the AIFMD, subject to delayed implementation for non-EU AIFs and non-EU AIFMs, introduces a single market for the managing and marketing of EU and non-EU AIFs by authorized and passported EU and non-EU AIFMs without imposing a fully harmonized operating regime on the AIFs.
- 1.12** The fact that a Member State may or may not regulate an AIF established in its jurisdiction does not restrict an authorized AIFM’s rights under the AIFMD to market that AIF in another Member State. For example, if an AIFM authorized by the competent regulator in the UK manages an Irish qualifying investor fund (QIF) and seeks to market that QIF in France pursuant to its passporting rights, the French authorities cannot impose additional requirements on the Irish QIF nor the UK AIFM in respect of that QIF.¹²

2. Private law aspects of the AIFMD

- 1.13** The AIFMD is regulatory law and therefore, by its very nature, a public law. It prescribes rules for AIFMs, who are persons who engage in activities that are regulated pursuant to the AIFMD. Accordingly, the purpose of the rules is to prescribe general conduct and organizational standards to which the regulated firm must adhere in order to be authorized to conduct its regulated business.
- 1.14** The purpose of regulatory law is not to create private law rights and liabilities between the regulated firm and third parties, be they clients of the firm or otherwise. Nevertheless, the AIFMD includes provisions that appear to reference private law rights of the AIF and of the investors in the AIF in Article 19(10) (liability of the AIFM for the valuation function), Article 20(3) (liability of the AIFM for a delegated function), and Article 21(12) and (13) (liability of the depositary). In addition, Article 37(13) (jurisdiction clause) appears to imply a mandatory forum choice into any contractual relationship.
- 1.15** Article 19(10) provides in the first paragraph that ‘AIFMs are responsible for the proper valuation of AIF assets, the calculation of the net asset value and the publication of that net asset value. The AIFM’s liability towards the AIF and its investors shall, therefore, not be affected by the fact that the AIFM has appointed an external valuer’. Similarly, Article 20(3) provides that the ‘AIFM’s liability towards the AIF and its investors shall not be affected by the fact that the AIFM has delegated functions to a third party’, and under Article 21(13) the ‘depositary’s liability shall not be affected by any delegation’.
- 1.16** These provisions could be read as regulatory requirements on AIFMs and depositaries not to seek to avoid responsibility for delegated functions. Indeed, Article 21(6)(e) specifies as one of the conditions for the appointment of the depositary that it must ‘by contract be liable to the AIF or to the investors of the AIF, consistently with paragraphs 12 and 13’.

¹¹ See AIFMD, recital (10).

¹² See AIFMD, recital (10).

If the provisions must be read as regulatory requirements, an AIFM or depository that seeks to contractually exclude liability for the delegated function would be breaching regulatory requirements, but that breach per se would not also invalidate or subvert the contractual arrangement. If the applicable private law recognizes some form of limitation on the ability of a party contractually to exclude liability, it is conceivable that breach of a regulatory requirement would be interpreted by the competent court to constitute a failure of the contractual exclusion to meet the applicable test for, eg, fairness or reasonableness, and therefore, that the attempted exclusion of liability is set aside. **1.17**

However, other provisions use much more direct language. The second paragraph of Article 19(10) reads: 'notwithstanding the first subparagraph and *irrespective of any contractual arrangements providing otherwise*, the external valuer *shall be 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'. Article 21(12) provides in the first paragraph that the 'depository *shall be liable* to the AIF or to the investors of the AIF, for the loss... of financial instruments held in custody' and in the third paragraph that the 'depository *shall also be liable* to the AIF, or to the investors of the AIF, for all other losses suffered by them as a result of the depository's negligent or intentional failure to properly fulfil its obligations pursuant to this Directive'.¹³ **1.18**

This liability language is plain in intention and purpose. It purports to create or preserve, as the case may be under the applicable national private law, private rights of action against the AIFM and the depository for the AIF and its investors. If challenged in the national courts, the European principle of effectiveness, known as *effet utile*, will probably operate to the effect that contractual arrangements or rules of national private law that seek to exclude, mitigate, or alter any liability of the AIFM or depository as envisaged by Article 19(10), 20(3), or 21(12) and (13) will be set aside.¹⁴ **1.19**

It is not clear, however, what the nature of these private rights of action is. Is it a statutory right of action? Is it to be implied in the contractual relationship, if any, between the injured parties and the AIFM or the depository, or does it set a negligence standard that gives separate actions in tort to the injured parties? Further, are the rights of action meant to be independently enforced by investors in the AIF or is it a collective action? And if it is a collective action, is the AIF responsible for enforcement? **1.20**

Article 37(13) contains a jurisdiction clause and provides that 'Any disputes between the [non-EU] AIFM or the AIF and EU investors of the relevant AIF shall be settled in **1.21**

¹³ Emphases added.

¹⁴ See, on the principle of effectiveness in European Union law, *inter alia*: T. Tridimas, *The General Principles of EU Law* (2nd edn, Oxford University Press, 2006), 418–76; W. van Gerven, 'Of Rights, Remedies and Procedures' (2000) 37 CMLR 501. Cf. on the principle of effectiveness in relation to breach of duties under Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (OJ 2004 L145/1) ('MiFID'): ECJ 30 May 2013, C-604/11, *Ars Aequi* (2013) 663 with annotation by D. Busch (*Genil 48 SL and others/Bankinter SA and others*), para 57, read in conjunction with ECJ 19 July 2012, C-591/10 (*Littlewoods Retail*, C-591/10), para 27.

accordance with the law of and subject to the jurisdiction of a Member State'. Again, it is not clear how this provision is intended to work in the context of national civil procedure rules. Are contrary contractual choices of law clauses set aside? What law of which Member State applies? Does this affect conflicts of laws forum selection rules in the context of tortious liability?

- 1.22** It would appear that these matters have not been given much consideration by the draftsmen of the AIFMD. National implementation and judicial interpretation will have to provide clarity.

3. Policy reasons for the expansion of the EU regulatory framework for investment funds

A. The stated case for the AIFMD

- 1.23** The first three recitals of the AIFMD aim to make the case for expansion of the scope of the EU regulatory framework for investment funds. Recital (1) notes that managers of AIFs are 'responsible for the management of a significant amount of invested assets in the Union, account for significant amounts of trading in markets for financial instruments, and can exercise an important influence on markets and companies in which they invest'. Recital (2) asserts that the 'impact of AIFMs on the markets in which they operate is largely beneficial, but recent financial difficulties have underlined how the activities of AIFMs may also serve to spread or amplify risks through the financial system'; and recital (3) concludes that '[r]ecent difficulties in financial markets have underlined that many AIFM strategies are vulnerable to some or several important risks in relation to investors, other market participants and markets'.

- 1.24** More detail relating to the policy rationale can be found in an Explanatory Memorandum to the Commission's April 2009 proposal for the AIFMD. Here, the Commission wrote:¹⁵

The financial crisis has exposed a series of vulnerabilities in the global financial system. It has highlighted how risks crystallising in one sector can be transmitted rapidly around the financial system, with serious repercussions for all financial market participants and for the stability of the underlying markets. . . . The proposed legislation will introduce harmonised requirements for entities engaged in the management and administration of alternative investment funds (AIFM).

- 1.25** The Commission justifies the need for 'closer regulatory engagement with this sector' with a reference to reports produced by the European Parliament¹⁶ and the High-Level Group on Financial Supervision chaired by Jacques de Larosière.¹⁷ Neither report, however, appears to suggest that there is a need to expand the regulatory framework for investment funds in the EU to the level the AIFMD has ultimately introduced. The reports merely note the need for governments and regulators to gain a better understanding of the level of leverage

¹⁵ See Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers (n 8).

¹⁶ Report of the European Parliament with recommendations to the Commission on hedge funds and private equity (A6-0338/2008) ('Rasmussen report') and on the transparency of institutional investors (A6-0296-2008) ('Lehne report').

¹⁷ Report of the High-Level Group on Financial Supervision in the EU, 25 February 2009 ('De Larosière report') 25.

and the size of the investments made by (specifically) hedge funds and private equity funds. The limited findings of the Rasmussen and De Larosière reports do not appear to provide a proper basis for the Commission's policy rationale for the introduction of the AIFMD in its final form.

The Commission further observes in the Explanatory Memorandum that the 'financial crisis has underlined the extent to which AIFMs are vulnerable to a wide range of risks' and that these risks are 'of direct concern to the investors in those funds, but also present a threat to creditors, trading counterparties and to the stability and integrity of European financial markets'. **1.26**

The Commission lists the following risk categories. **1.27**

- (a) Macro-prudential (systemic) risks, defined as 'direct exposure of systemically important banks to the AIFM sector' and 'pro-cyclical impact of herding and risk concentrations in particular market segments and deleveraging on the liquidity and stability of financial markets'.
- (b) Micro-prudential risks, defined as 'weakness in internal risk management systems with respect to market risk, counterparty risks, funding liquidity risks and operational risks'.
- (c) Investor protection risks, defined as 'inadequate investor disclosures on investment policy, risk management, internal processes' and 'conflicts of interest and failures in fund governance, in particular with respect to remuneration, valuation and administration'.
- (d) Market efficiency and integrity risks, defined as the 'impact of dynamic trading and short selling techniques on market functioning' and the 'potential for market abuse in connection with certain techniques, for example short-selling'.
- (e) Risks relating to the impact on market for corporate control, defined as 'lack of transparency when building stakes in listed companies, e.g. through use of stock borrowing, contracts for difference, or concerted action in "activist" strategies'.
- (f) Impact on companies controlled by AIFMs, defined as the 'potential for misalignment of incentives in management of portfolio companies, in particular in relation to the use of debt financing' and the 'lack of transparency and public scrutiny of companies subject to buy-outs'.

B. The questionable logic of the arguments for the AIFMD

Of the risk categories listed by the Commission in the Explanatory Memorandum, only (b) and (c) appear special to the fund industry. Categories (a), (d), (e), and (f) are general matters that concern all market participants, whether or not they are fund vehicles. The question may be asked, therefore, whether the risks cited in categories (a), (d), (e), and (f) can serve properly as (part of) the policy rationale for EU legislation that aims to regulate the fund industry. Prima facie, it would appear not. In this context, it is worth noting that short-selling risks (see category (d)) are specifically addressed in a separate European short-selling regulation applying to all market participants.¹⁸ **1.28**

Other arguments made by the Commission are similarly questionable. The Explanatory Memorandum states that 'AIFM were not the cause of the crisis', but that the 'risks associated **1.29**

¹⁸ Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (OJ 2012 L86/1).

with their activities have manifested themselves throughout the AIFM industry over recent months and may in some cases have contributed to market turbulence'. By way of example, the Commission observes that 'hedge funds have contributed to asset price inflation and the rapid growth of structured credit markets', and that the 'abrupt unwinding of large, leveraged positions in response to tightening credit conditions and investor redemption requests has had a pro-cyclical impact on declining markets and may have impaired market liquidity'.¹⁹ Forced selling by funds will certainly have increased the pressure on market, thus decreasing liquidity. This would qualify as a category (a) risk. However, forced selling in distressed market conditions is not special to investment funds and it is not clear why operators of AIFs, or indeed the investors in AIFs, ought to be singled out for regulation on this basis. *All* market participants contribute to asset price inflation.

- 1.30** Equally, the fact that funds-of-hedge-funds have 'faced serious liquidity problems' causing 'some funds-of-hedge-funds to suspend or otherwise limit redemptions', as the Commission notes,²⁰ does not constitute a meaningful policy reason for regulation of AIF in the manner proposed. In the event that the markets in which assets comprised in the pool ceases, temporarily or permanently, to be accessible or reliable, the operator of the scheme may need to suspend redemptions and contributions. That is a feature of investment in the particular market, not a feature special to collective investment arrangements. *Any* participant in that particular market, whether or not an 'alternative investment fund', would be faced with a dearth of trading opportunities as well as challenges to obtaining a reliable price.
- 1.31** While there may be good reasons in relation to particular types of AIFs, notably funds that operate a highly leveraged investment strategy, to seek transparency from the operators of those types of AIFs in relation to the AIFs' trading positions—as argued in the Rasmussen and De Larosière reports—the policy reasons put forward by the Commission to justify the proposed regulatory intervention in the non-UCITS investment fund industry appear to lack focus. Even if there were special systemic risks associated with AIFs as defined in the AIFMD, for which the Commission has provided no evidence, it remains unclear why such risks justify, for instance, broad-brush strict restitutionary liability for depositaries of AIFs that fail—in a singularly uninformed manner—to recognize the complex legal reality of cross-border custody services.

C. Conclusion

- 1.32** It is difficult to avoid the conclusion that the AIFMD is the product of rushed and opportunistic rule-making, driven by the political environment *du jour* rather than considered and informed policy. Indeed, the name of the Directive is a stark reminder of the (initial) lack of political focus. It wrongly and opportunistically brands the AIFMD as merely designed to regulate private equity funds and hedge funds.²¹

¹⁹ De Larosière report (n 17) 25.

²⁰ Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers (n 8), Explanatory Memorandum.

²¹ Charles McGreevy, then European Commissioner for Internal Market and Services and a former Irish Minister for Finance, noted in an EC hosted conference on alternative investment funds in February 2009 on the topic of regulating hedge funds and private equity funds: 'Hedge funds and private equity were the poster-boys of the new finance. They surfed the wave of abundant liquidity and cheap credit. Now, as the financial system crumbles, they are easy scapegoats for more deep-rooted problems', quoted by D.A. Zetzsche, 'Introduction', in D Zetzsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International, 2012) 4. See also at p 9 in reference to the muddled political debate.

As a result, while the broad notions of regulating (the management of) non-UCITS funds and creating a single market for the offering of these funds to professional investors undoubtedly make good economic policy, the AIFMD presents a chequered landscape that lacks intellectual coherence. **1.33**

When it concerns the ability of pension funds, insurance companies, and other financial intermediaries to access the world's asset managers so as to ensure optimized portfolio selection—which is the best guarantee for optimized risk-return calibration—investors and product providers alike should be able to expect law-making based on careful consideration of broad-based empirical evidence and technically sound and informed analysis. European lawmakers, high-minded in the wake of a financial crisis, did not quite manage to apply the care and diligence required to make responsible law for the financial markets—the life blood of the modern economical cycle for allocation of capital from household savings and investments. **1.34**

4. Legislative structure

A. The Lamfalussy procedure

Since the mid-2000s, EU financial services legislation is created at several levels'. This process is known as the 'Lamfalussy procedure'.²² Level 1 constitutes 'framework legislation, typically in the form of a directive of the Council and the European Parliament that must be implemented by the Member States through national legislation. **1.35**

Level 2 consists of implementing measures that are made by the Commission, referred to as 'delegated acts'. Delegated acts are typically made in a combination of regulations, which apply directly in the Member States, and directives, which must be implemented through national legislation. **1.36**

Level 3 consists of specialist work of various bodies made up of representatives of national regulators. The Level 3 bodies make regulatory guidelines that apply to market participants and national regulators directly, as well as technical standards to assist the Commission in making delegated acts. **1.37**

The operative Lamfalussy organizing principle is that certain rules are clarified into further detail at a later stage, leaving the setting of main principles at primary legislative level, i.e. the European Council and the European Parliament, and permitting specialist rules to be made at Level 2 and Level 3 without the need to seek ratification from the Level 1 legislative bodies, although these bodies are typically given the right to object to proposals within a certain period.²³ **1.38**

The original Level 3 bodies were the Committee of European Banking Supervisors (CEBS),²⁴ the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS),²⁵ and the Committee of European Securities Regulators (CESR).²⁶ These committees have recently been abolished and replaced by newly formed 'European Supervisory Authorities' **1.39**

²² A reference to the four-level regulatory approach recommended by the 'Committee of Wise Men on the Regulation of European Securities Markets', chaired by Baron Alexandre Lamfalussy, whose proposals were adopted by the Council of Economics and Finance Ministers, 22 March 2001.

²³ See eg AIFMD, recital (86) and Art 58.

²⁴ Established by Commission Decision 2004/5/EC and revised by Commission Decision 2009/78/EC.

²⁵ Established by Commission Decision 2004/6/EC and revised by Commission Decision 2009/79/EC.

²⁶ Established by Commission Decision 2001/527/EC and revised by Commission Decision 2009/77/EC.

(ESAs), operative since 1 January 2011. The ESAs are the European Banking Authority (EBA),²⁷ the European Insurance and Occupational Pensions Authority (EIOPA),²⁸ and the European Securities and Markets Authority (ESMA).²⁹

- 1.40** The ESAs form part of the newly conceived ‘European System of Financial Supervision’ (ESFS). The ESFS is designed as an integrated network of national and EU supervisory authorities, leaving day-to-day supervision to the national level. It seeks to ‘overcome deficiencies’ in the pan-European regulatory framework and to ‘provide a system that is in line with the objective of a stable and single Union financial market for financial services, linking national supervisors within a strong Union network’.³⁰ Apart from the ESAs, the ESFS comprises the European Systemic Risk Board (ESRB),³¹ the Joint Committee of the European Supervisory Authorities,³² and the national regulators.³³

B. The AIFMD framework

- 1.41** The AIFMD constitutes Level 1 framework legislation. The AIFMD empowers and instructs the Commission to make further Level 2 rules by way of delegated acts. It concerns: Article 3 (exemptions), Article 4 (definitions), Article 9 (initial capital and own funds), Articles 12 and 14–21 (operating conditions for AIFMs), Articles 22–24 (transparency requirements), Article 25 (leverage), Articles 34–37, 40, 42, and 67–68 (non-EU AIFs and AIFMs), and Article 57 (exchange of information between regulators).³⁴
- 1.42** To date, the Commission has adopted three regulations to supplement the rules in the AIFMD. The bulk of the Level 2 measures are contained in Regulation No 231/2013 of 19 December 2012 (Implementing Regulation).³⁵ The Implementing Regulation deals with most matters that are delegated to the Commission under the AIFMD, except

²⁷ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ 2010 L331/12).

²⁸ Established by Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ 2010 L331/48).

²⁹ Established by 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 (‘ESMA Regulation’).

³⁰ See (the identical) recital (8) of each of Regulations (EU) Nos 1093/2010, 1094/2010, and 1095/2010, establishing EBA, EIOPA and ESMA, respectively (the recitals further note that: ‘The Union cannot remain in a situation where there is no mechanism to ensure that national supervisors arrive at the best possible supervisory decisions for cross-border financial market participants; where there is insufficient cooperation and information exchange between national supervisors; where joint action by national authorities requires complicated arrangements to take account of the patchwork of regulatory and supervisory requirements; where national solutions are most often the only feasible option in responding to problems at the level of the Union; and where different interpretations of the same legal text exist’).

³¹ Established by Regulation (EU) No 1092/2010 European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (OJ 2010 L331/1).

³² Per Arts 54–57 of Regulations (EU) Nos 1093/2010, 1094/2010, and 1095/2010.

³³ Per Art 1(2) of Regulations (EU) Nos 1093/2010, 1094/2010, and 1095/2010.

³⁴ See recitals (78) et seq.; Art 56 AIFMD.

³⁵ Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (OJ 2013 L83/1) (‘Implementing Regulation’). The remaining chapters of this book will refer to this Regulation simply as the ‘Implementing Regulation’.

the opt-in procedure for AIFMs that meet the exemption conditions of Article 3(2)³⁶ and the selection of the Member State of reference for certain non-EU AIFMs.³⁷

The relevant ESA under the AIFMD is ESMA. Articles 10–14 of the ESMA Regulation empower ESMA to make regulatory technical standards in relation to matters in which the Commission has been given the power to make delegated acts.³⁸ **1.43**

The regulatory technical standards must be ‘technical’ so as not to ‘imply strategic decisions or policy choices’ and their scope is delineated by the scope of the delegated acts to which they relate.³⁹ ESMA must conduct public consultations and cost/benefit analyses in relation to draft technical standards, except if disproportionate or in matters of urgency.⁴⁰ The Commission may reject ESMA’s proposed technical standards and ask for variations, and, indeed, has done so in relation to a number of areas in connection with the AIFMD. **1.44**

Article 16 of the ESMA Regulation empowers ESMA to make guidelines and recommendations. These apply to national regulators and/or market participants. The objective is to further the consistency, efficiency, and efficacy of the ‘supervisory practices within the European System of Financial Supervision’ (ESFS) and to ensure ‘the common, uniform and consistent application of Union law’.⁴¹ Here, too, ESMA must conduct public consultations and cost/benefit analyses in relation to draft guidelines and recommendations, except if disproportionate or in matters of urgency.⁴² **1.45**

II. General Provisions of the AIFMD

1. Subject matter and scope (Articles 1–2)

A. Subject matter (Articles 1 and 2(1))

Article 1 sets the scene: the AIFMD creates a regulatory framework for the authorization and regulation of ‘managers of alternative investment funds (AIFMs) which manage and/or market alternative investment funds (AIFs) in the Union’. **1.46**

Article 2(1) puts beyond doubt that any connection of an AIFM with the EU, either because the AIFM is based in the EU or, if not, manages an EU AIF or markets an AIF in the EU, will bring the AIFM in scope. Accordingly, EU AIFMs which manage one or more EU or non-EU AIFs, non-EU AIFMs which manage one or more EU AIFs, and non-EU AIFMs which market one or more EU or non-EU AIFs in the EU, subject to applicable exclusions and exemptions, all need authorization under the AIFMD. **1.47**

³⁶ Per AIFMD, Art 3(4). This delegated act is dealt with in Commission Implementing Regulation (EU) No 447/2013 of 15 May 2013 establishing the procedure for AIFMs which choose to opt in under Directive 2011/61/EU of the European Parliament and of the Council (OJ 2013 L132/1) (‘Opt-In Implementing Regulation (EU) No 447/2013’).

³⁷ AIFMD, Art 37(14). This delegated act is dealt with in the Opt-In Implementing Regulation (EU) No 447/2013.

³⁸ In addition to the AIFMD giving the Commission the power to make delegated acts, similar provisions may be found, inter alia, in MiFID (n 14) and the UCITS Directive (n 2): see ESMA Regulation (n 29), Art 1(2).

³⁹ ESMA Regulation (n 29), Art 10(1).

⁴⁰ ESMA Regulation (n 29), Art 10(1).

⁴¹ ESMA Regulation (n 29), Art 16.

⁴² ESMA Regulation (n 29), Art 16.

- 1.48** The AIFMD, therefore, is not directed at AIFs per se.⁴³ It seeks to regulate the operators, or ‘managers’, of AIFs—the AIFMs. Naturally, certain elements of the constitution and operation of AIFs are regulated indirectly by requiring the AIFM as part of its continued authorization to ensure that its AIFs are AIFMD-compliant.
- 1.49** Unless the AIF is a ‘self-managed’ AIF, so that it is also authorized as the AIFM,⁴⁴ the compliance of the AIF will not ultimately be within the control of the AIFM. The AIFM will be required to resign as manager to the AIF in the event that the AIF fails to comply with the AIFMD.⁴⁵
- 1.50** Accordingly, the scope of the AIFMD depends on three operative concepts: ‘AIF’, ‘managing’ an AIF in the EU, and ‘marketing’ an AIF in the EU. These definitions are addressed in turn.

B. Scope: what is an ‘AIF’? (Articles 2(2) and 4(1)(a))

- 1.51** An ‘AIF’ is defined in Article 4(1)(a) of the AIFMD as a collective investment undertaking, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorization pursuant to the UCITS Directive.⁴⁶
- 1.52** Article 2(2) makes it clear that the structure of the arrangement, form (legal structure), or substance (open-ended or closed-ended) is of no consequence to the determination of whether or not an arrangement is an AIF.
- 1.53** The definition is clearly, and presumably purposefully, broad and inclusive. ESMA has made guidelines on the meaning of AIF⁴⁷ but this guidance is of a very general nature and does little to bring more certainty. ESMA does not wish (unintentionally) to narrow the scope of Article 4(1)(a).⁴⁸
- 1.54** Accordingly, the only certainty is that UCITSs are not AIFs. All other elements—ie ‘collective investment’, ‘undertaking’, ‘raising capital’, ‘from a number of investors’, ‘with a view to investing’, ‘defined investment policy’, and ‘investing for the benefit of the investors’—are capable of variable interpretations ensuring that unless there is some form of exclusion, any arrangement that has collective investment characteristics is potentially in scope.
- 1.55** For instance, the notions of ‘collective investment’, ‘investing for the benefit of the investors’, and ‘defined investment policy’ are de facto largely non-descript. At first blush, it may be tempting to conclude that this is about arrangements that enable a number of participants, the investors, to ‘pool’ their assets and have the combined assets managed as a single fund in accordance with a certain investment objective so that they may share equally, pro rata to their participation, in the profits and losses of the pool as well as the cost of operation. However, many commercial arrangements are based on the notion of pooling resources and sharing profits and losses.
- 1.56** Even determining, for purposes of the definition of AIF, whether an undertaking has a number of investors or only one investor is not straightforward. Except where the undertaking is

⁴³ AIFMD, recital (10) notes specifically that the AIFMD does not seek to regulate AIFs per se.

⁴⁴ AIFMD, recital (20).

⁴⁵ AIFMD, recital (11).

⁴⁶ AIFMD, Art 4(1)(a).

⁴⁷ ESMA, *Guidelines on key concepts of the AIFMD*, ESMA/2013/611, 13 August 2013.

⁴⁸ See ESMA, *Final Report—Guidelines on key concepts of the AIFMD*, ESMA/2013/600, 24 May 2013, para 4.

legally prevented, for example by law or its constitutional instrument, from raising capital from more than one investor, it should be considered an AIF notwithstanding that, de facto, there is only one investor.⁴⁹ Naturally, if the sole investor is funded by multiple investors, look-through applies.⁵⁰

In practice, it will be necessary for providers of investment and other financial products to consider each product offered in the EU carefully to assess whether it is caught by the AIFMD. That means screening against the implementation rules of the Member State in which the AIFM manages the AIF as well as the rules of each Member State in which the AIF may be offered. **1.57**

C. Exclusions from the definition of AIF (Article 2(3))

Certain arrangements have been excluded from the definition of AIF by Article 2(3) AIFMD. The most obvious exclusion is the company, ie a business enterprise that participates in commerce in contractual or corporate form and seeks capital funding, privately or publicly, by way of a fixed number of equity participations. Where the enterprise concerns farming, building, manufacturing, or the sale of goods or services, it will not be difficult to identify the factors that distinguish the company from a collective investment arrangement.⁵¹ If, however, the company's enterprise is the purchase and sale of financial investments, for its own account, the matter is less straight forward. Holding companies are therefore excluded from the definition of AIF.⁵² But the definition of holding company itself leaves grey areas. **1.58**

Pension funds also operate collective investment arrangements. A defined benefit scheme disconnects the participants' entitlements from the actual investment return and may be characterized more properly as a form of insurance. Defined contribution schemes, however, often offer participants a choice of investment options which are each organized and managed as a pool and may in some manner be characterized as investment funds. Most pension schemes would qualify as AIFs but for the exclusion from the definition of AIF.⁵³ **1.59**

Other exclusions are supranational and national governmental bodies, including central banks and bodies that manage assets meant to fund social security obligations, as well as, helpfully, employee participation and savings schemes.⁵⁴ **1.60**

Equally, unit-linked insurance policies, which pay out by reference to the value of a portfolio of investment funds that the policyholder may select during the life of the policy to invest the insurance premiums in, are well within reach of the definition of AIF. Interestingly, Recital (8) of the AIFMD observes that the Directive 'should not apply to the management of pension funds; employee participation or savings schemes; supranational institutions; national central banks; national, regional and local governments and bodies or institutions which manage funds supporting social security and pension systems; securitisation special purpose entities; or *insurance contracts* and joint ventures'.⁵⁵ All these arrangements have been **1.61**

⁴⁹ ESMA, *Guidelines on key concepts of the AIFMD* (n 48), Guideline 17.

⁵⁰ ESMA, *Guidelines on key concepts of the AIFMD* (n 48), Guideline 18.

⁵¹ Indeed, ESMA has no difficulty excluding 'undertakings' that have a 'general commercial or industrial purpose' from the definition of AIF: see ESMA, *Guidelines on key concepts of the AIFMD* (n 48), Guideline 12.

⁵² AIFMD, Art 2(3)(a).

⁵³ AIFMD, Art 2(3)(b), (e).

⁵⁴ AIFMD, Art 2(3)(c)-(f).

⁵⁵ Emphasis added.

listed as excluded from the definition of 'AIF' in Article 2(3), with the exception of insurance contracts. Notwithstanding, presumably, insurance services and insurance contracts are intended to be excluded from the scope of the AIFMD.

D. Grey area: notional pools may or may not be AIFs

- 1.62** The distinction between financial arrangements that constitute collective investment proper, and other financial arrangements, which operate to pay the participants a share of the profit and loss but are not collective investment, is most clearly obfuscated in the case of (off-balance sheet) asset-backed securitizations and (on-balance sheet) 'structured debt' instruments.
- 1.63** In the case of asset-backed securitizations, a special purpose vehicle will issue debt instruments. The proceeds of the issue will be used to buy a portfolio of assets from the originator, the arranger of the securitization, for example credit card debts or mortgaged loans. The returns of the portfolio of assets are used to fund the payments due under the issued debt instruments. The AIFMD does not aim to capture these arrangements and 'securitisation special purpose entities' have been excluded from the definition of AIF.⁵⁶
- 1.64** Unlike securitization vehicles, structured debt arrangements are not excluded and may, prima facie, be caught. Structured debt arrangements entail a financial institution that has the benefit of a commercial credit rating to issue debt expressed to pay interest and principal by reference to the return of a notional pool of assets.
- 1.65** Consequently, all debt holders will share equally in the rise and fall of the reference value. Similarly, total return swap transactions may reference baskets of financial instruments arrangements. If the swap provider writes a number of swaps referencing an identical basket, the swap counterparties will share in the return of that basket. From some perspective, it may be said that these series of bilateral contractual arrangements amount to collective investment and are therefore AIFs. That conclusion, however, would not be right and appropriate in view of the definition of 'AIF' in the AIFMD, certainly not if interpreted in the context of the AIFMD's stated rationale.
- 1.66** The primary *raison d'être* for the AIFMD is the management of systemic risk. Structured debt and swap transactions are balance sheet events for the issuer. The proceeds are not used to invest in an actual pool of assets for the benefit of its counterparties. The reference value remains a notional pool and the issuer will typically ensure that it can make payments by entering into swap and other investment transactions that will protect the issuer from any adverse movement in the value of the notional pool.
- 1.67** It is difficult to see how, in these arrangements—per Article 4(1)(a)(i)—capital has been raised from a number of investors 'with a view to investing it'. The proceeds of the transactions—'it' in the definition of AIF—are not invested but will fund the issuer's general operations and will be used by the issuer as principal, not as operator of a collective investment scheme. Systemic risk arising from these arrangements should be addressed as a matter of the regulation of the operations of the issuer as a financial institution, for example a credit institution, not as an AIFM.
- 1.68** The secondary aim of the AIFMD is investor protection. It concerns protection from certain market and other operational risks. In that context, the AIFMD seeks to impose operational

⁵⁶ AIFMD, Art 2(3)(g).

requirements on the AIFM that aim to mitigate the potential impact of certain events. In particular, the AIFMD imposes risk and liquidity management and requirements in Articles 15 and 16 and a depositary requirement in Article 21.

These risk mitigation requirements are not meaningful in the context of a notional pool. Again: the proceeds, 'it', are not invested. The AIFMD, therefore, is not the right tool to regulate investment products which are bilateral contracts that determine the product provider's payment obligations by reference to a notional pool of assets. A better approach is to regulate the governance of these products, and risk mitigation, as a matter of the regulated business of the issuer, ie either in the context of authorization as an investment firm under MiFID or in the context of the authorization as a credit institution under the Banking Directive.⁵⁷ Indeed, the governance of unit-linked insurance policies is left to be regulated under the Life Insurance Directive.⁵⁸ Naturally, a level playing field should be preserved in terms of operative conduct of business rules and product restrictions on market access.⁵⁹ **1.69**

It may perhaps also be argued in certain circumstances that contracts that pay out by reference to notional pools are not 'undertakings' within the meaning of Article 4(1)(a). However, it is not clear what is meant by an 'undertaking'. Article 2(2) refers to any 'legal form', which seems to make clear that the AIF does not need to have a legal personality, but not whether and to what extent an arrangement must have a separate existence of some description to constitute an AIF. Since capital must be raised from 'a number of investors' in order for there to be an AIF, arrangements that do not have legal personality should at least be a multi-partite arrangement to be considered as an AIF. **1.70**

E. Scope: 'managing' an AIF (Article 4(1)(w))

The AIFMD lists the key components of 'managing an AIF' in Article 4(1)(w) and Annex I, which together stipulate that 'managing AIFs' means performing 'at least' the 'investment management functions' of 'portfolio management' or 'risk management' for one or more AIFs. **1.71**

The drafting gives rise to confusion because Article 4(1)(w) appears to suggest that to be the AIFM, it is sufficient to be appointed either as the portfolio manager *or* as the risk manager. **1.72**

⁵⁷ 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 (OJ 2006 L177/1).

⁵⁸ Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance (OJ 2002 L345/1).

⁵⁹ See also Proposal for a Regulation of the European Parliament and of the Council on key information documents for investment products, COM(2012) 352 final, 3 July 2012 (also known as the 'Packaged Retail Investment Products Regulation' or 'PRIIPs'). According to PRIIPs, 'investment products' must be accompanied by a key information document (KID) when sold to 'retail investors'. 'Investment product' is broadly defined and captures all investments where, regardless of the legal form of the investment, the amount repayable to the investor is exposed to fluctuations in reference values or in the performance of one or more assets which are not directly purchased by the investor (Art 4(a)). According to the Explanatory Memorandum (p 7), '[s]uch a definition would include products with capital guarantees, and those where, in addition to capital, a proportion of the return is also guaranteed; investment funds, whether closed-ended or open-ended including UCITS; all structured products, whatever their form (e.g. packaged as insurance policies, funds, securities or banking products), insurance products whose surrender values are determined indirectly by returns on the insurance companies own investments or even the profitability of the insurance company itself as well as derivative instruments. Some of these products may be used as individual retail pension products, i.e. accumulation vehicles for the purposes of retirement planning'. Although not explicitly mentioned, AIFs offered to retail investors appear to be within the scope of PRIIPs as well.

The wording in paragraph 1 of Annex I of the AIFMD does not use the word ‘or’, however, and Article 6(5)(d) provides that an AIFM must be appointed by the AIF to perform both functions in order to be authorized under the AIFMD.⁶⁰

- 1.73** For a collective investment scheme to run properly, in essence, three different categories of functions must be performed: portfolio management functions (the investment and reinvestment of the assets of the collective investment scheme); administrative functions (the valuation of the assets, pricing of the shares or units, and cancellation and issue of units or shares, including settlement of the transactions with the investors, an activity known as ‘transfer agency’); and marketing and distribution functions.
- 1.74** In this context, it is instructive to compare the AIFMD’s definition of ‘managing an AIF’ to the UCITS Directive’s definition of ‘managing a UCITS’. Annex II of the UCITS Directive is clear on the point that ‘managing a UCITS’, also referred to as ‘collective portfolio management’, includes all three categories.⁶¹ In other words, the person who seeks to ‘manage a UCITS’ must be appointed by that UCITS to perform, and must have assumed responsibility to the UCITS for the performance of, all three categories of functions, together defined as ‘collective portfolio management’ by Annex II of the UCITS Directive.
- 1.75** The AIFMD takes a different approach. Although Annex I uses the words ‘collective management of an AIF’ and clearly implies that this concept is similar to the concept of ‘collective portfolio management’ used in the UCITS Directive,⁶² Annex I also implies that, unlike a management company authorized under the UCITS Directive, it is not mandatory for an AIFM to be appointed by the AIF to perform the administrative or marketing functions. Responsibility for investment management functions, ie portfolio management and risk management as defined in Annex I of the AIFMD, is sufficient.
- 1.76** Portfolio management and risk management are not defined in the AIFMD. Some confusion may therefore arise about the meaning of ‘portfolio management’ in the context of ‘management of a collective investment undertaking’ (be that a UCITS or an AIF).
- 1.77** It is clear that there is no functional difference between managing a portfolio of investments that belongs to an individual and managing a portfolio of investments that belongs to a collective investment undertaking. In both cases the portfolio manager is responsible for the investment and reinvestment of the portfolio, on a discretionary basis, with a view to pursuing a certain investment objective.
- 1.78** A person who manages the investment and reinvestment of the portfolio of an AIF is therefore not necessarily the ‘manager’ of that AIF, ie the AIFM. If that were true, all persons who provide MiFID portfolio management services to an AIF would be managing the AIF within the meaning of the AIFMD, and they are not.⁶³ For a person to be the AIFM, there needs to be an additional, collective element. That must logically mean that the AIFM is the person who has assumed responsibility for the overall performance of the various functions listed in Annex I of the AIFMD in the context of the operation of the collective investment scheme.

⁶⁰ See also recital (21), which (definitively) proclaims that an AIFM ‘should never be authorised to provide portfolio management without also providing risk management or *vice versa*’.

⁶¹ See UCITS Directive (n 2), Art 6(2), (3) and Annex II.

⁶² AIFMD, Annex I, paras 2(a), (b) are exact copies of the second and third bullets of Annex I of the UCITS Directive (n 2).

⁶³ See paras 1.140–1.142.

For instance, where it concerns portfolio management, responsibility for portfolio liquidity management in view of expected redemptions and contributions is a collective element in the management of the portfolio that is not present in individual portfolio management. This distinguishes the portfolio management role of an AIFM, or indeed a UCITS management company, from the portfolio management role of a MiFID investment firm. Naturally, the AIFM (or UCITS management company) can delegate the responsibility to a MiFID investment firm. **1.79**

Merely advising the AIF is not sufficient, even if that function is accompanied by risk management.⁶⁴ There must be discretionary investment powers, ie the AIFM must have discretion to make investment decisions within the boundaries of the agreed investment policy and the investment restrictions. **1.80**

F. Scope: ‘marketing’ an AIF (Article 4(1)(x))

‘Marketing’ is defined in Article 4(1)(x) AIFMD as a ‘direct or indirect offering or placement’, made ‘at the initiative of the AIFM’ or ‘on behalf of the AIFM’, to or with investors who are domiciled in the EU or who have a registered office in the EU, ‘of units or shares of an AIF’ managed by the AIFM. **1.81**

The offering or placement must be made ‘at the initiative of the AIFM’ or persons in its distribution channel. Accordingly, if the units or shares are purchased at the investor’s initiative, commonly referred to as ‘reverse solicitation’, no ‘marketing’ within the meaning of the AIFMD has occurred. Recital (70) clarifies that the AIFMD is not intended to apply if an EU-based professional investor ‘invests in AIFs on its own initiative, irrespective of where the AIFM and/or the AIF is established’. **1.82**

Pension funds and other institutional investors are often assisted by professional consultants who solicit product information from investment managers through so-called ‘requests for proposals’ or ‘RFPs’. It is very likely that investments in AIFs pursuant to these RFPs properly qualify as having been made at the initiative of the investor, rather than the AIFM. Much of this is fact and context bound, of course, and will also depend on national implementation and guidance from the national regulators. **1.83**

Given that the offer or placement must be made ‘at the initiative of the AIFM’ or ‘on behalf of the AIFM’, it follows that the AIFM is only responsible for offerings or placements made through a distribution channel controlled by the AIFM. If a person, for example a broker, who is not authorized by or on behalf of the AIFM (eg by way of a distribution agreement or otherwise), offers or places units or shares in an AIF to or with an investor in the EU, the offering or placement does not cause the AIFM to be in breach of the AIFMD. **1.84**

That would potentially leave a hole in the regulatory net because an AIF is a collective investment scheme and, therefore, units or shares in an AIF are financial instruments within the meaning of Section C of Annex I to MiFID. Investment firms authorized under MiFID and credit institutions authorized to provide MiFID services would therefore be able to offer or place units in non-compliant AIFs in the EU in accordance with their regulatory permissions. **1.85**

The AIFMD deals with the potential gap in Article 6(8), which provides that ‘investment firms’, which ‘directly or indirectly, offer units or shares of AIFs to, or place such units or **1.86**

⁶⁴ See also E. Wymeersch, ‘The European Alternative Investment Fund Management Directive’, in E. Wymeersch (ed.), *Alternative Investment Fund Regulation* (Kluwer Law International, 2012) 437.

shares with, investors in the EU, may only do so to the extent the units or shares can be marketed in accordance with' the AIFMD.⁶⁵

- 1.87** In view of recital (9) AIFMD, the term 'investment firm' as used in Article 6(8) ought to be interpreted within the meaning of Article 1(1) MiFID, without reference to any exemptions so as to capture all firms that engage in investment services within the meaning of MiFID, regardless of whether or not these firms are based in the EU, and regardless of whether or not they are authorized under MiFID.
- 1.88** The wording of Article 6(8) suggests that the prohibition on 'offering' or 'placing' of units by an investment firm is limited to activities that amount to marketing. Therefore, an investment firm should be free to advise a client within the meaning of Article 4(1)(4) of MiFID to purchase units in an AIF,⁶⁶ even if that AIF could not otherwise be marketed to that client in accordance with the AIFMD. Equally, per the definition of 'marketing' in Article 4(1)(x) and recital (70), if the firm executes an order on behalf of but at the initiative of the client,⁶⁷ the resulting transaction ought not to amount to offering or placing.

2. Exemptions (Article 3)

- 1.89** Separately from the exclusions in Article 2(3), the AIFMD offers a number of exemptions in Article 3. Group company investment vehicles are exempted and the AIFMD does not apply to the extent that the AIF's only investors are the AIFM or its group companies, provided these are not themselves AIFs.⁶⁸
- 1.90** In addition, the AIFMD operates a materiality threshold and does not apply to an AIFM to the extent that:
- (a) in the case of AIFs that employ leverage, the aggregate value of the long assets of all the leveraged AIFs under common control of the AIFM does not exceed EUR 100 million;⁶⁹
 - (b) in the case of AIFs that do not employ leverage and are closed-ended for a period of at least five years, the aggregate value of the long assets of all the AIFs under common control of the AIFM does not exceed EUR 500 million.⁷⁰
- 1.91** The Commission has made Level 2 rules in relation to the calculation, monitoring, and reporting of the assets under management by an AIFM who seeks to avail of the materiality threshold exemptions.⁷¹ In summary: annually, the AIFM must calculate the aggregate value of all the assets held in each AIF it manages under common control, including those portfolios delegated to third parties, but UCITS portfolios, portfolios delegated to the AIFM by third parties, and cross-investments between the AIFs or their sub-funds, are excluded.⁷²
- 1.92** The assets must be valued in accordance with the rules that apply to the AIF per its constitutive documents and the laws of its place of organization.⁷³ Derivative instruments, however, including

⁶⁵ AIFMD, Art 6(8). See also recital (9).

⁶⁶ Which is an investment service within the meaning of MiFID (n 14), Annex I, Section A(5).

⁶⁷ Which is an investment service within the meaning of MiFID (n 14), Annex I, Section A(2).

⁶⁸ AIFMD, Art 3(1). See also recital (16).

⁶⁹ AIFMD, Art 3(2)(a). See also recital (17).

⁷⁰ AIFMD, Art 3(1). See also recital (17).

⁷¹ Per AIFMD, Art 3(6).

⁷² Implementing Regulation, Art 2(1), (2), (4)–(6).

⁷³ Implementing Regulation, Art 2(1)(b).

instruments with embedded derivatives such as convertible bonds, must be valued in accordance with the ‘conversion methodology’ set out in the Commission’s Implementing Regulation.⁷⁴

AIFMs who have the benefit of the materiality threshold exemption are not fully exempted from the AIFMD: the AIFM must register with its national regulator and regularly provide information about its AIFs, the investment strategies, and the holdings and the principal activities, as well as monitor the value of the assets under management and notify its regulator immediately in the event that the AIFM fails to continue to qualify for the exemption due to a breach of the applicable threshold.⁷⁵ Breaches that are expected to be temporary may not disqualify the AIFM if the AIFM is able to provide reasonable justification for its assessment that the breach is temporary in nature.⁷⁶ However, breaches that are likely to continue for longer than three months are not considered to be temporary in nature.⁷⁷ **1.93**

3. Determination of AIFM (Article 5(1))

A. Appointment to manage an AIF

Article 5(1) of the AIFMD directs the Member States to ensure that each AIF ‘shall have a single AIFM, which shall be responsible for ensuring compliance with [the AIFMD]’. To be the AIFM, a person must ‘manage the AIF’. **1.94**

As discussed in paragraph 1.75, Article 4(1)(w), in conjunction with Annex I, implies that, unlike a management company authorized under the UCITS Directive, it is not mandatory for an AIFM to be appointed by the AIF to perform the administrative or marketing functions. Responsibility for investment management functions, ie portfolio management and risk management as defined in Annex I of the AIFMD, is sufficient. **1.95**

The Directive’s splitting of ‘investment management functions’ (portfolio management and risk management) from other collective management functions reconciles with the fact that the AIFMD does not regulate AIFs directly. Unless an AIF is ‘self-managed’, so that it is also authorized as the AIFM,⁷⁸ the compliance of the AIF will not ultimately be within the control of the ‘external’ AIFM. Instead, the AIFMD requires the AIFM, rather than each AIF, to ensure that the AIFs under its purview comply with the Directive.⁷⁹ The AIFM will be required to resign as manager of the AIF in the event that the AIF fails to comply with the AIFMD.⁸⁰ **1.96**

The ability to allocate certain collective management functions to different persons will allow the depositary to assume responsibility for the administrative functions. This makes sense as, in practice, it is the depositary who performs the valuation and transfer agency functions for the AIF. **1.97**

B. Internally managed versus externally managed AIFs

Article 5(1) permits the AIFM to be either a person which is appointed separately by or on behalf of the AIF to manage the AIF (‘external AIFM’), or to be the AIF itself, if its legal **1.98**

⁷⁴ Implementing Regulation, Art 2(3). Under Art 10, the conversion methodology is set out in Annex II of the Implementing Regulation.

⁷⁵ AIFMD, Art 3(3) and the implementing rules in the Implementing Regulation, Arts 3–5. See also the Implementing Regulation, recitals (6)–(9).

⁷⁶ Implementing Regulation, Art 4(3).

⁷⁷ Implementing Regulation, Art 4(4).

⁷⁸ See AIFMD, recital (20).

⁷⁹ AIFMD, Art 5(2).

⁸⁰ See AIFMD, Art 5(3) and recital (11).

form permits a governance structure that allows for self-management of the AIF ('internal management') by a governing body of the AIF and the governing body has not decided to appoint an external AIFM.⁸¹

- 1.99** The distinction between the self-managed, or 'internally managed', AIF and an AIF that is 'externally managed', ie has appointed an AIFMD management company, is of particular consequence for the capital requirements imposed by Article 9.
- 1.100** In practice, investment funds are structured in one of four forms: in corporate form as a company with variable capital; in contractual form as a partnership operated by a (usually incorporated) general partner; in contractual form as a common fund held by a depositary company and managed by a management company; or in the form of a (unit) trust operated by a (usually incorporated) trustee. Only the company with variable capital has a governance structure that permits self-management through its governing bodies, the board of directors, and/or shareholders.
- 1.101** AIFs that exist in contractual or trust form do not normally have independent governing bodies. They are managed through their general partner, management company, or trustee who, therefore, would in the first instance qualify as the AIFM. However, nothing in the AIFMD suggests that authorization as an internally managed AIF in a trust or contractual common fund is not permitted if the constitutive documents of the AIF establish a board or other governing body that is charged with the Annex I investment management functions. For purposes of Article 9, it is conceivable that the capital requirement of EUR 300,000 would be contributed to the trust or contractual common fund by the sponsor of the AIF by way of subordinated units or shares that are only redeemable if all ordinary unit or shareholders have been paid in full.

4. Types of AIFM and AIFs

A. Open-ended and closed-ended AIFs

- 1.102** Application of Article 16 (liquidity management), Article 19 (valuation), and Article 61 (transitional provisions) of the AIFMD differs depending on whether the AIFM's AIFs are open-ended or closed-ended.
- 1.103** Open-ended collective investment funds do not normally have a fixed term, and permit investors to make contributions and request redemptions at certain times during the life of the fund. The number of units or shares issued to an investor in return for contributions to the fund and the amount payable to the investor by the fund upon cancellation of units or shares following a redemption request are based on the price of the unit or share on the day of the contribution or redemption (known as the 'dealing day'). The price is calculated by dividing the net asset value of the fund—ie the assets minus the liabilities as determined based on prevailing market prices and in accordance with the rules applicable to the fund under its constitutive documents and the law of its place of organization—by the number of outstanding units or shares on the dealing day. The contribution, or the redemption amount, as the case may be, is payable upon the contribution or redemption becoming binding on the investor and the fund.
- 1.104** Closed-ended collective investment funds have a fixed term and do not permit additional contributions of privately offered closed-ended funds after the fund has closed following the capital-raising cycle. During the capital-raising period, each investor agrees on the amount of

⁸¹ See also recital (20).

capital it will commit to the fund. Once the aggregate of the investors' capital commitments reaches a certain threshold determined by the manager of the fund, the capital-raising cycle ends and the fund is said to be 'closed'. The next phase is the investment phase, in which the manager will seek out investment opportunities. The investment will, apart from bank borrowing, be funded by 'drawing down' capital commitments, or, later in the life of the fund, by the proceeds from the sale of earlier investments. This will continue until the manager has invested the entire committed capital. In the final phase, the manager will sell the investments of the fund one by one and return capital, plus or minus the return on the particular investment, to the investors.

Accordingly, open-ended and (privately offered) closed-ended funds have fundamentally different *modi operandi*. Open-ended funds accept contributions and will permit investors to take their capital out on a continuous, all be it not always high frequency, basis. The share of the investor in the pool is valued based on prevailing market prices that will be obtained from public sources. Closed-ended funds are not open for continuous contributions and redemptions and are perhaps best described as a series of collective investments in individual assets that are funded by the investor and lenders at the time of purchase. Capital is only returned once the investment is sold. Thus, the values of the capital contributions to, and the redemptions from, open-ended funds are determined based on estimated prices, notwithstanding the fact that the manager will normally have to sell fund assets to meet the redemption request. The values of the capital draw-downs and return from closed-ended funds, on the other hand, are based on actual prices. **1.105**

Different operational processes have different implications for the liquidity profile and valuation of the fund. The manager of an open-ended fund is concerned with meeting redemption requests out of the portfolio and ensuring that the valuation of the redeemed units is accurate and fair to the remaining investors; the redeeming investor should not be over- nor underpaid. The manager of the closed-ended fund, on the other hand, returns the proceeds of the actual divestment to all investors once the asset has been successfully sold. Liquidity does not play a role in that process and the valuation is a mere calculus event based on the actually achieved price, not an estimation based on a collection of prevailing market values. **1.106**

Naturally, the ability to operate an open-ended fund depends on the availability of reliable market prices, as well as relatively liquid markets for the assets in which the fund invests so that the manager may sell assets to meet the redemption requests. If the assets are less liquid, the manager must limit the frequency of the dealing days. Some funds that invest in illiquid hedge fund strategies operate with annual or even less frequent dealing days. At some point, it is tempting to conclude that the fund cannot be said to be open-ended. **1.107**

Indeed, this is what ESMA, after consultation, wrote into its initial draft 'regulatory technical standards' (RTS) relating to 'types of AIFM'.⁸² Recital (3) of ESMA's initial draft RTS observes that the distinction between open-ended and closed-ended funds should be determined based on 'an appropriate threshold for the frequency of redemption opportunities offered to AIF investors given the particular relevance thereof to the rules on liquidity management and valuation procedures' and that given 'current market practice, it is appropriate to consider as open-ended those AIFs which offer redemption frequencies of at least yearly'. **1.108**

⁸² See ESMA, *Final report Draft regulatory technical standards on types of AIFMs*, ESMA/2013/413, 2 April 2013, submitted to the Commission for endorsement of the draft RTS pursuant to Art 10(1) of the ESMA Regulation (n 29).

- 1.109** As demonstrated, however, exactly because of the fundamental difference between valuation of investor interests in open-ended and closed-ended funds, the redemption opportunity, no matter how infrequent, would appear to be the wrong determinant. Rather, what matters is whether contributions and redemptions are driven by the manager's investment opportunity and consequently by funding needs or liquidation proceeds of actual investment transactions.
- 1.110** The Commission concurs. In a letter dated 4 July 2013, the Commission wrote to ESMA that it has 'serious doubts' whether the frequency of the ability to redeem is a criterion that can be used to distinguish between open-ended and closed-ended funds. The Commission observed that Articles 16(1) and 19(3) of the AIFMD, in conjunction, denote a closed-ended fund as a fund which carries out valuations 'in case of an increase or decrease of the capital by the relevant AIF', and concludes that in case of a closed-ended fund, the 'valuation and calculation frequency is therefore linked solely to increases or decreases of its capital'.
- 1.111** ESMA disagreed with the Commission's response to its initial draft RTS for several reasons, mostly based on the practical implications of the liquidity and valuation rules for funds that have a low dealing frequency, ie less than once a year.⁸³ Notwithstanding, ESMA submitted re-drafted RTS to the Commission 'in order to ensure a timely implementation of the AIFMD provisions and move the process forward'.⁸⁴
- 1.112** Article 1(2) of the re-drafted RTS provides that an open-ended AIF is an 'AIF the shares or units of which are, at the request of any of its shareholders or unit holders, repurchased or redeemed prior to the commencement of its liquidation phase or wind-down'. Under Article 1(3) of the re-drafted RTS, a closed-ended AIF is an AIF that is not an open-ended AIF within the meaning of Article 1(1).
- 1.113** This approach—to base the distinction on whether the fund returns capital to investors after a sale of investment rather than at the request of the investor—is in line with what the market will in practice deem to be the difference between open-ended and closed-ended funds.⁸⁵

B. Leveraged and unleveraged AIFs

- 1.114** In addition to the distinction between internally and externally managed AIFs, and between open-ended or closed-ended AIFs, the application of the AIFMD may differ depending on whether the AIF is considered to be (substantially) leveraged or unleveraged. This affects the application of Article 5(2) (exemptions) and Article 16 (liquidity management). Separately, AIFMs managing leveraged AIFs are subject to special duties under Article 25 (AIFMs managing leveraged AIFs).
- 1.115** The dictionary definition of 'leverage' describes it as the mechanical advantage gained by the use of a lever. A lever permits the use of the benefit of *momentum* so that less force is required to lift an object than if the object were lifted directly. In the context of investment, leverage denotes the *momentum* that is experienced when the market exposure of the investment of own funds is increased through the use of financial levers, ie financial transactions that result in the ability to make profits, or incur losses, from market movements of certain defined investments without investing own funds equal to the principal value of those investments at the time of the transaction.

⁸³ See ESMA, *Opinion—Draft regulatory technical standards on types of AIFMs under Art 4(4) of Directive 2011/61/EU*, 2013/ESMA/1119, 13 August 2013, paras 10ff.

⁸⁴ ESMA, *Opinion* (n 83), para 34.

⁸⁵ At the time of writing, the Commission had not yet issued final RTS in relation to types of AIFM.

Leveraged exposure can be achieved in different ways. The most straightforward is to invest borrowed money. If the lender is prepared to provide an unsecured loan, the investor does not need own funds and has maximum *momentum*. More commonly, the lender will require the purchased investment as collateral and require the investor to invest own funds in addition to the borrowed funds, thus creating a buffer in the value of the collateral and protecting the lender against adverse market movements. **1.116**

A common way to achieve leveraged market exposure is to enter into a forward contract or future. For instance, the purchaser of an index future will typically be required to provide only 10% of collateral value against the purchased value. EUR 10.00 thus permits the conclusion of a forward contract that gives EUR 100.00 market exposure. Similarly, someone who writes a put or a call option on an index may only have to provide collateral to the tune of 10% of the value to which the put or call relates. The buyer of the option is in a slightly different position, as only the premium is due and the option will naturally only be exercised if it is in the money. **1.117**

Swap agreements can also provide leverage. For instance, an unfunded total return swap will permit the purchaser against the payment of a periodic fee calculated as a rate, for example LIBOR plus 0.30%, applied on the value of the reference asset, known as the 'notional value', to gain market exposure to virtually any asset class, limited only by the requirement to collateralize the future payments due to the provider of the total return swap. **1.118**

A more complex and common set of transactions that give leveraged exposure is called 'shorting'. The investor sells EUR 100.00 of certain financial instruments that are not actually owned and borrows the instruments from a third party to satisfy the delivery obligation. The proceeds of the short sale, plus any top-up with own funds as may be required by the lender, are provided as collateral for the securities loan. If the lender permits it, the short-seller may also choose to use the proceeds to buy different financial instruments and provide those as collateral instead of the cash proceeds of the short transaction, in which case the short-seller is said to have both a 'long' and a 'short' exposure to the market. **1.119**

C. Determining whether an AIF is leveraged

The term 'leverage' is defined in Article 4(1)(v) of the AIFMD as 'any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means'. This broad definition captures the numerous ways in which any market participant, collective investment fund, or otherwise, can seek to gain exposure to certain investments without investing own funds to the value of those investments.⁸⁶ **1.120**

As instructed in Article 4(1)(3), the Commission has duly provided rules on the measurement and calculation of leverage in Articles 6–11 of the Implementing Regulation. Article 6(1) of the Implementing Regulation provides that leverage of an AIF shall be expressed as the ratio between its exposure and its net asset value. **1.121**

It is important to note that it concerns the exposure of the AIF and not the exposure of issuers of instruments in which the AIF is invested. While investments with embedded derivatives, for example convertible bonds, are captured, investment in a leveraged issuer is not a leveraged transaction for the AIF. This matters in the context of closed-ended funds, which invest, for example, in private equity or real estate, as they tend to make investments through **1.122**

⁸⁶ Annex I of the Implementing Regulation lists methods that may be used to increase the exposure of an AIF.

portfolio companies for tax and ring-fencing reasons. Portfolio companies typically obtain bank loans to fund their investments. The AIF would become exposed, however, if it agreed to guarantee any of the loans made to the portfolio companies.⁸⁷

- 1.123** In addition, calculation of exposure excludes ‘any borrowings that are temporary in nature and fully covered by capital commitments from investors’,⁸⁸ permitting the avoidance of settlement failures through temporary bridging facilities without tipping the AIF into a leveraged AIF regime.
- 1.124** The exposure must be calculated in two ways: using the gross methodology and using the commitment methodology.⁸⁹ Gross exposure is the ‘sum of the absolute values of all positions’ of the AIF,⁹⁰ but excludes cash and cash equivalents and unused cash borrowings.⁹¹ Positions are to be valued in accordance with the rules set out in the AIF’s constitutive documents and the laws under which the AIF is organized,⁹² but derivative instruments are valued using the conversion methodology set out in Annex I and II of the Implementing Regulation.⁹³ Positions funded through the reinvestment of cash borrowings are to be valued at the higher of the value of the cash borrowing or the position funded with the proceeds of the borrowing.⁹⁴ Repurchase and securities lending agreements are valued in accordance with paragraphs (3) and (10) to (13) of Annex I.⁹⁵
- 1.125** The commitment methodology also starts with the sum of the absolute values of all positions of the AIF.⁹⁶ However, all cash and cash borrowings are included. Again, positions are to be valued in accordance with the rules set out in the AIF’s constitutive documents and the laws under which the AIF is organized.⁹⁷ Derivative instruments are to be valued using the conversion methodology set out in Annex I and II,⁹⁸ *except that* total return swaps written by the AIF are not included,⁹⁹ forward contract or futures purchased by the AIF if fully covered with cash positions are not included,¹⁰⁰ and foreign exchange forward contracts, if used for currency hedging purposes, are not included.¹⁰¹ Positions funded through cash borrowings are to be valued at the higher of the value of the cash borrowing or the position funded with the proceeds of the borrowing.¹⁰² Repurchase and securities lending agreements are valued in accordance with paragraphs 3 and 10–13 of Annex I of the Implementing Regulation.¹⁰³ Next, opposite positions must be netted where applicable¹⁰⁴ and qualifying hedging arrangements must be taken into account.¹⁰⁵

⁸⁷ Implementing Regulation, Art 6(3).

⁸⁸ Implementing Regulation, Art 6(4). Revolving credit facilities should not be considered since they are temporary in nature: see Implementing Regulation, recital (14).

⁸⁹ Implementing Regulation, Art 6(2).

⁹⁰ Implementing Regulation, Art 7.

⁹¹ Implementing Regulation, Art 7(a), (c).

⁹² AIFMD, Art 19(1).

⁹³ Implementing Regulation, Arts 7(b), 10.

⁹⁴ Implementing Regulation, Art 7(d).

⁹⁵ Implementing Regulation, Art 7(e).

⁹⁶ Implementing Regulation, Art 8(1).

⁹⁷ Implementing Regulation, Art 8(1).

⁹⁸ Implementing Regulation, Arts 8(2)(a), 10.

⁹⁹ Implementing Regulation, Art 8(4).

¹⁰⁰ Implementing Regulation, Art 8(5).

¹⁰¹ Implementing Regulation, Art 8(7).

¹⁰² Implementing Regulation, Art 8(2)(c), Annex 1, paras 1, 2.

¹⁰³ Implementing Regulation, Art 8(2)(d).

¹⁰⁴ Implementing Regulation, Art 8(2)(b), (8), which list the conditions for netting.

¹⁰⁵ Implementing Regulation, Art 8(2)(b), (6), which list the qualifying criteria, which are, in essence, that there must be identifiable and verifiable reduction of market exposure.

The rationale put forward for the use of these two methodologies is that the combination is the best basis for ‘an objective overview of the leverage used’.¹⁰⁶ The idea is that the gross method provides the overall exposure while the commitment method ‘gives insight in the hedging and netting techniques used’.¹⁰⁷ **1.126**

There is something to be said for that, as the gross calculation adds up all positions, minus cash, regardless of whether the position is long or short, thus showing the absolute value of the market exposure, treating cash as nil exposure. The commitment method shows the relative value of the market exposure, including cash, but neutralizing all positions that may be properly regarded as hedged or netted. If the commitment exposure is equal to the net asset value (NAV), the AIF can be said to be not leveraged as it has not increased its market exposure beyond the value of its own funds. Notwithstanding, the gross exposure may still show whether or not the AIFM extensively employs derivatives for hedging and market exposure purposes. **1.127**

As noted, Article 6(1) of the Implementing Regulation provides that the leverage of an AIF ‘shall be expressed as the ratio between the exposure of the AIF and its net asset value’. It does not clarify what the position is if the ratio is 1 based on the commitment exposure, suggesting that the AIF is not leveraged, but greater than 1 if based on the gross exposure. This could happen if the AIF uses derivatives to hedge positions, for example foreign exchange forward contracts (‘fx forwards’), and gain fully funded market exposure. **1.128**

The AIF is considered to be ‘substantially leveraged’ if the ratio of the commitment exposure to NAV exceeds 3.¹⁰⁸ In that case, Article 24(4) of the AIFMD imposes special reporting duties. **1.129**

III. Authorization to Manage an AIF

1. Overview: EU AIFMs and non-EU AIFMs

A. Jurisdiction of a Member State

Under Article 1(1), the AIFMD’s objective is to ensure that it is prohibited to ‘manage an AIF’ in the EU without prior authorization. In practical terms, this means that each Member State must ensure that ‘managing an AIF’ is a regulated activity that requires a licence or some other form of authorization if it is carried out in that Member State. **1.130**

An activity is carried out in a Member State if the AIFM is domiciled in the Member State or a foreign AIFM manages an AIF that is domiciled in that Member State. The foreign AIFM may seek to establish a branch or representative office. **1.131**

In the case of a domestic AIFM, authorization from the home Member State is required pursuant to Article 6(1) of the AIFMD. Subject to conditions, an exemption from compliance with Articles 21 (depository) and 22 (disclosure requirements) applies by virtue of Article 34 to the extent that the domestic AIFM manages non-EU AIFs which are not marketed in the EU. **1.132**

¹⁰⁶ Implementing Regulation, recital (11).

¹⁰⁷ Implementing Regulation, recital (12).

¹⁰⁸ Implementing Regulation, Art 111 and recital (132).

- 1.133** In the case of a non-domestic EU AIFM, that AIFM may rely on its home state authorization to provide management services cross-border into another Member State under Article 33. An EU AIFM may also establish a branch in another Member State.
- 1.134** Non-EU AIFMs that manage an EU AIF will be required to be authorized by their Member State of reference pursuant to Article 37. Non-EU AIFMs may rely on such authorizations to provide management services cross-border into another Member State under Article 41.
- 1.135** A non-EU AIFM that is managing a non-EU AIF, logically, is not ‘managing an AIF in the EU’. However, if the non-EU AIFM wishes to market its non-EU AIF in one or more Member States, it would need authorization to manage the AIF from its Member State of reference under Article 37.
- 1.136** Articles 37 and 41 of the Directive will not come into force until July 2015.¹⁰⁹ It is not immediately clear from the text of the AIFMD what the position is in relation to authorization of non-EU AIFMs *ad interim*. On the face of Article 6(1), which refers to AIFMs without distinction between EU AIFMs and non-EU AIFMs, it would appear that until Article 37 comes into force, Member States have to treat non-EU AIFMs that manage domestic AIFs as domestic AIFMs. However, given that Article 42 permits marketing of both EU and non-EU AIFs managed by non-EU AIFMs subject to a special (partly national) regime, the better interpretation is that the authorization of non-EU AIFMs remains subject to national authorization regimes until Article 37 comes into force. Indeed, that appears to be the position most Member States are taking.
- 1.137** The application of Articles 6, 33, 34, and 37 are discussed in detail in section III.2.

B. Scope of authorization

- 1.138** Authorization to manage an AIF includes portfolio management and risk management, and may include non-core AIFMD administrative services (valuation and transfer agency) and marketing.¹¹⁰
- 1.139** In addition, under Annex I, paragraph 2(c) of the AIFMD, authorization for non-core services may include authority to engage in ‘activities related to the assets of AIFs’. These are defined as: services necessary to meet the fiduciary duties of the AIFM, facilities management, real estate administration activities, advice to undertakings on capital structure, industrial strategy and related matters, advice and services relating to mergers, and the purchase of undertakings and other services connected to the management of the AIF and the companies and other assets in which it has invested. These are all activities that are usual in the context of closed-ended funds that invest in real estate, private equity, and infrastructure projects.

C. MiFID services to an AIF are not in scope of the AIFMD prohibition

- 1.140** Individual portfolio management by investment firms or credit institutions of portfolios owned by collective investment funds or collective pension schemes is the norm rather than the exception. Typically, an MiFID portfolio manager is appointed as a delegated manager

¹⁰⁹ AIFMD, Art 66(3) delays implementation of Arts 35 and 37–41 until activated by a Commission delegated act made pursuant to Art 67(6). The delegated act must be adopted three months after ESMA has given positive advice pursuant to Art 67(1) on extending passporting rights for the marketing of non-EU AIFs by EU AIFMs within the meaning of Arts 35 and 37–41. ESMA must give advice by 22 July 2015.

¹¹⁰ AIFMD, Annex I, para 2(a).

by the fund if it is self-managed, or by the management company of the fund if it is managed externally, to manage the fund's assets.¹¹¹

Article 6(8) of the AIFMD provides that investment firms authorized under MiFID and credit institutions authorized under the Banking Directive do not require authorization under the AIFMD to provide MiFID investment services, such as individual portfolio management, to AIFs. Similarly, investment firms established in a third country, which, under the applicable national law may provide investment services in respect of AIFs, do not require separate AIFMD authorization.¹¹² **1.141**

It is not obvious why the European legislator deemed it necessary to provide explicitly for this exclusion. Investment services such as investment advice and portfolio management are clearly not 'management of an AIF'. **1.142**

D. UCITS management company

UCITS management companies authorized under the UCITS Directive must also be authorized under the AIFMD if they wish to manage and market AIFs or take up any other activities as an AIFM.¹¹³ However, the competent authorities do not require UCITS companies to provide information or documents which the UCITS management company already provided when applying for authorization under the UCITS Directive (provided that such information or documents remain up to date).¹¹⁴ **1.143**

E. MiFID services by an AIFM

Member States have the *option* of authorizing an external AIFM to carry out certain MiFID services. The authorization would concern the core business of 'individual' portfolio management,¹¹⁵ and may include the non-core businesses of investment advice,¹¹⁶ safe-keeping, and administration in relation to shares or units of collective investment undertakings,¹¹⁷ and reception and transmission of orders in relation to financial instruments.¹¹⁸ **1.144**

¹¹¹ Which, in case of pension schemes, is permitted under Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (OJ 2003 L235/10), Art 19(1).

¹¹² AIFMD, recital (9).

¹¹³ The reverse is also true: external AIFMs wishing to manage UCITSs require separate authorization pursuant to the UCITS Directive (n 2). See AIFMD, Art 6(2) *in fine* and recital (21).

¹¹⁴ AIFMD, Art 7(4).

¹¹⁵ AIFMD, Art 6(4)(a). See, for a similar provision with respect to UCITS management companies, UCITS Directive (n 2), Art 6(3)(a).

¹¹⁶ See, for a similar provision with respect to UCITS management companies, UCITS Directive (n 2), Art 6(3)(b)(i).

¹¹⁷ See, for a similar provision with respect to UCITS management companies, UCITS Directive (n 2), Art 6(3)(b)(ii). Note that under the European Commission's proposal for MiFID II of 20 October 2011 (COM (2011) 656 final), safe-keeping and administration qualifies as an investment service and no longer as an ancillary service. See MiFID II, Annex I, section A, sub (9). However, note that under the Council's MiFID II compromise text of 18 June 2013 (2011/0298 (COD), No 11006/13), safe-keeping and administration still qualifies as an ancillary service and not as an investment service. See MiFID II, Annex I, section B, sub (7).

¹¹⁸ See AIFMD, Art 6(4)(b). Note that Art 6(4)(a) and (b) derogate from Art 6(2), which provides that 'Member States shall require that no external AIFM engage in activities other than those referred to in Annex I to [the AIFMD] and the additional management of UCITS subject to authorisation under [the UCITS Directive, n 2]'.

- 1.145** AIFMs authorized to carry out MiFID services must comply, inter alia, with the MiFID initial capital requirements, organizational requirements, and conduct of business obligations.¹¹⁹ Accordingly, the AIFM will have to meet both MiFID and AIFMD initial capital requirements, organizational requirements, and the conduct of business obligations.¹²⁰
- 1.146** There are some restrictions. AIFMs may not be authorized for MiFID business only.¹²¹ Further, the MiFID authorization must at least include portfolio management to permit authorization for the non-core MiFID business.¹²² This makes sense, as the core business of an AIFM should be management of the AIF. In addition, the AIFM is not authorized only to perform the non-core AIFMD services.¹²³ Finally, AIFMs are not authorized to provide the AIFMD core service of collective portfolio management without also providing the AIFMD core service of risk management, or vice versa.¹²⁴ Both these restrictions may be explained by the fact that the core business of an AIFM should always be collective portfolio and risk management. However, these restrictions do not prevent an AIFM from delegating collective portfolio and risk management in accordance with the AIFMD.¹²⁵

2. Authorization and passporting of EU AIFMs

A. Authorization of EU AIFMs (Article 6)

- 1.147** A Member State will require an AIFM domiciled in its territory and which manages one or more AIFs, regardless of the location of its AIFs and regardless of whether its AIFs are marketed in the EU, to be authorized by the Member State's national regulator. In these circumstances, the Member State is the 'home Member State' of the AIFM.¹²⁶

B. Exemptions for EU AIFMs from Articles 21 and 22 where non-EU AIFs are not marketed in the EU (Article 34)

- 1.148** To facilitate the domestic EU management industry that provides services outside the EU, Article 34(1) of the AIFMD provides for a partial exemption for EU AIFMs that manage non-EU AIFs not marketed in the EU.
- 1.149** The EU AIFM is exempted from compliance with Articles 21 (depository) and 22 (disclosure requirements) in respect of those AIFs if it complies with all other requirements, and

¹¹⁹ See AIFMD, Art 6(6) in conjunction with MiFID (n 14), Arts 12 (initial capital requirements), 13 (organizational requirements), and 19 (conduct of business rules). See also AIFMD, Art 6(6) in conjunction with MiFID (n 14), Art 2(2), which provides that '[t]he rights conferred by [MiFID, n 14] shall not extend to the provision of services as counterparty in transactions carried out by public bodies dealing with public debt or by members of the European System of Central Banks performing their tasks as provided for by the Treaty and the Statute of the European System of Central Banks and of the European Central Bank or performing equivalent functions under national provisions'.

¹²⁰ Cf. Wymeersch, 'The European Alternative Investment Fund Management Directive' (n 64) 447, n 68.

¹²¹ AIFMD, Art 6(5)(a) and recital (21). See, for a similar provision with respect to UCITS management companies, UCITS Directive (n 2), Art 6(3), last paragraph.

¹²² AIFMD, Art 6(5)(b) and recital (21). See, for a similar provision with respect to UCITS management companies, UCITS Directive (n 2), Art 6(3), last paragraph.

¹²³ AIFMD, Art 6(5)(c) and recital (21).

¹²⁴ AIFMD, Art 6(5)(d) and recital (21).

¹²⁵ See AIFMD, Art 20 on delegation. See also Wymeersch, 'The European Alternative Investment Fund Management Directive' (n 64) 444.

¹²⁶ AIFMD, Art 4(1)(q).

appropriate cooperation arrangements are in place between the national EU regulator and the supervisory authorities of the third country where the non-EU AIF is established.

The purpose of the cooperation agreements is ‘to ensure at least an efficient exchange of information that allows competent authorities of the home Member State of the AIFM to carry out their duties’ under the AIFMD.¹²⁷ **1.150**

C. Passporting by EU AIFMs of management authorization (Article 33)

Member States must ensure that an EU AIFM authorized by another Member State may manage EU AIFs established in their territory either on a cross-border basis or by establishing a branch, provided that the AIFM is authorized by the other Member State to manage that type of AIF.¹²⁸ **1.151**

An AIFM intending to manage EU AIFs established in another Member State for the first time must notify its national regulator of the Member State in which it intends to manage AIFs directly, or establish a branch,¹²⁹ and provide a ‘programme of operations’ stating in particular the services which it intends to perform and identifying the AIFs it intends to manage.¹³⁰ **1.152**

If the AIFM intends to establish a branch, it must provide additional information on: the organizational structure of the branch;¹³¹ the address in the home Member State of the AIF from which documents may be obtained;¹³² and the names and contact details of the persons responsible for the management of the branch.^{133, 134} **1.153**

The competent authorities of the home Member State of the AIFM must, within one month of receiving the notification in the case of direct management, or within two months in the case of establishment of a branch, transmit the complete notification file to the competent **1.154**

¹²⁷ AIFMD, Art 34(1)(b). Implementing Regulation, Arts 113–115 contain rules designed to provide a common EU framework to facilitate the establishment of those cooperation arrangements with third countries.

¹²⁸ AIFMD, Art 33(1). See, for a similar provision, but formulated from the perspective of the UCITS rather than the UCITS management company, UCITS Directive (n 2), Art 16(3).

¹²⁹ AIFMD, Art 33(2)(a). See, for similar provisions, UCITS Directive (n 2), Arts 17(2)(a) (branch) and 18(1)(a) (cross-border).

¹³⁰ AIFMD, Art 33(2)(b). See, for similar provisions, UCITS Directive (n 2), Arts 17(2)(b) (branch) and 18(1)(b) (cross-border). In order to ensure consistent harmonization, ESMA may develop draft regulatory technical standards to specify the information to be notified (AIFMD, Art 33(7), first paragraph). Power is delegated to the Commission to adopt these regulatory technical standards in accordance with ESMA Regulation (n 29), Arts 10–14 (AIFMD, Art 33(7), second paragraph). Furthermore, in order to ensure uniform conditions of application, ESMA may develop draft implementing technical standards to establish standard forms, templates, and procedures for the transmission of information (AIFMD, Art 33(8), first paragraph). Power is conferred on the Commission to adopt these implementing technical standards in accordance with ESMA Regulation (n 29), Art 15 (AIFMD, Art 33(8), second paragraph).

¹³¹ AIFMD, Art 33(3)(a).

¹³² AIFMD, Art 33(3)(b). See, for a similar provision, UCITS Directive (n 2), Art 17(2)(c).

¹³³ AIFMD, Art 33(3)(c) AIFMD. See, for a similar provision with respect to the establishment of a branch, UCITS Directive (n 2), Art 17(2)(d).

¹³⁴ In order to ensure consistent harmonization, ESMA may develop draft regulatory technical standards to specify the information to be notified (AIFMD, Art 33(7), first paragraph). Power is delegated to the Commission to adopt these regulatory technical standards in accordance with ESMA Regulation (n 29), Arts 10–14 (AIFMD, Art 33(7), second paragraph). Furthermore, in order to ensure uniform conditions of application, ESMA may develop draft implementing technical standards to establish standard forms, templates, and procedures for the transmission of information (AIFMD, Art 33(8), first paragraph). Power is conferred on the Commission to adopt these implementing technical standards in accordance with ESMA Regulation (n 29), Art 15 (AIFMD, Art 33(8), second paragraph).

authorities of the host Member State of the AIFM. Such transmission must occur only if the AIFM's management of the AIF complies, and will continue to comply, with the AIFMD and the AIFM otherwise complies with the AIFMD.¹³⁵

- 1.155** The competent authorities of the AIFM's home Member State must enclose a statement to the effect that the AIFM is authorized by that state.¹³⁶ The competent authorities of the home Member State must immediately notify the AIFM about the transmission.¹³⁷
- 1.156** Upon receipt of the transmission notification the AIFM may start to provide its services in its host Member State.¹³⁸ The host Member State of the AIFM must not impose any additional requirements on the AIFM in respect of the matters covered by the AIFMD.¹³⁹
- 1.157** In the event of a change to any of the information communicated in the notification file, an AIFM must give written notice of that change to the competent authorities of its home Member State at least one month before implementing planned changes, or immediately after an unplanned change has occurred.¹⁴⁰
- 1.158** If, pursuant to a planned change, the AIFM's management of the AIF would no longer comply with the AIFMD, or the AIFM would otherwise no longer comply with the AIFMD, the competent authorities of the AIFM's home Member State must inform the AIFM without undue delay that it is not to implement the change.¹⁴¹
- 1.159** If a planned change is implemented notwithstanding the above in paragraphs 1.157 and 1.158, or if an unplanned change has taken place pursuant to which the AIFM's management of the AIF would no longer comply with the AIFMD or the AIFM otherwise would no longer comply with the AIFMD, the competent authorities of the AIFM's home Member State must take all due measures in accordance with Article 46.¹⁴²
- 1.160** If the changes are acceptable because they do not affect the compliance of the AIFM's management of the AIF with the AIFMD, or the compliance by the AIFM with the AIFMD otherwise, the competent authorities of the AIFM's home Member State must, without undue delay, inform the competent authorities of the AIFM's host Member States of those changes.¹⁴³

3. Authorization and passporting of non-EU AIFMs

A. Authorization of non-EU AIFMs (Article 37)

- 1.161** Article 37(5) and (8) of the AIFMD provides that the non-EU AIFM must apply for authorization to its Member State of reference and follow the procedures and comply with the conditions set out in Articles 6–11, subject to certain amendments set out in Article 37(8).¹⁴⁴

¹³⁵ AIFMD, Art 33(4), first paragraph. See, for similar provisions, UCITS Directive (n 2), Art 17(3), first paragraph (branch) and Art 18(2), first paragraph (cross-border).

¹³⁶ AIFMD, Art 33(4), second paragraph.

¹³⁷ AIFMD, Art 33(4), third paragraph.

¹³⁸ AIFMD, Art 33(4), fourth paragraph. See, for similar provisions, UCITS Directive (n 2), Arts 17(7) (branch) and Art 18(2), last paragraph.

¹³⁹ AIFMD, Art 33(5).

¹⁴⁰ AIFMD, Art 33(6), first paragraph.

¹⁴¹ AIFMD, Art 33(6), second paragraph.

¹⁴² AIFMD, Art 33(6), third paragraph.

¹⁴³ AIFMD, Art 33(6), fourth paragraph. See, for somewhat different provisions with respect to changes, UCITS Directive (n 2), Arts 17(8) and (9) (branch) and Art 18(4) (cross-border).

¹⁴⁴ As discussed in para 1.136, Arts 37 and 41 do not come into force before 22 July 2015.

Article 37(4) sets out the rules for determining the Member State of reference of a non-EU AIFM that seeks authorization to manage one or more EU AIFs or to manage a non-EU AIF marketed in the EU. There are three reference points, set out in this table. **1.162**

	EU AIFs	Non-EU AIFs
<i>Not marketing</i>	[box 1]	[not relevant]
<i>Marketing with passport</i>	[box 2]*	[box 3]**

* Marketing in accordance with Article 39 (EU AIFs).

**Marketing in accordance with Article 40 (non-EU AIFs).

If the non-EU AIFM ticks box 1, it is not marketing the EU AIF in the EU and the home Member State of the AIF is the Member State of reference where the EU AIF is established. If it concerns multiple AIFs in multiple Member States, the Member State of reference is either the Member State where most of the AIFs are established or the Member State where the largest amount of assets is being managed.¹⁴⁵ **1.163**

If the non-EU AIFM ticks box 2 and it concerns only one EU AIF to be marketed in only one Member State, the Member State of reference, if the AIF is registered or authorized, is the home Member State of the AIF or the Member State where the AIFM intends to market the AIF, or, if the AIF is not authorized or registered in a Member State, the Member State where the AIFM intends to market the AIF. If a EU AIF is to be marketed in several Member States, the Member State of reference is the home Member State of the AIF where the AIF is registered or authorized, or one of the Member States where the AIFM intends to develop effective marketing, or, if the AIF is not authorized or registered in a Member State, one of the Member States where the AIFM intends to develop effective marketing. If it concerns several EU AIFs to be marketed in several Member States, the Member State of reference is, if they are all registered or authorized in the same Member State, that home Member State or the Member State where the AIFM intends to develop effective marketing for most of the AIFs, or, if the AIFs are not all registered or authorized in the same Member State, the Member State where the AIFM intends to develop effective marketing for most of those AIFs.¹⁴⁶ **1.164**

If the non-EU AIFM ticks box 3 and it concerns only one non-EU AIF to be marketed in only one Member State, the Member State of reference is that Member State. But if the non-EU AIF is to be marketed in different Member States, the Member State of reference is one of those Member States.¹⁴⁷ **1.165**

If the non-EU AIFM ticks both box 2 and box 3, the Member State of reference is the Member State where it intends to develop 'effective marketing' for most of the AIFs.¹⁴⁸ The non-EU AIFM may prove its intention to develop effective marketing in a particular Member State by disclosing its marketing strategy to the national regulator of that Member State.¹⁴⁹ **1.166**

¹⁴⁵ AIFMD, Art 37(4)(a) and (b).

¹⁴⁶ AIFMD, Art 37(4)(c), (e), (g).

¹⁴⁷ AIFMD, Art 37(4)(d), (f).

¹⁴⁸ AIFMD, Art 37(4)(h).

¹⁴⁹ AIFMD, Art 37(4), final paragraph.

1.167 If the rules point to more than one Member State of reference, the Member States shall require that the non-EU AIFM submits a request to the national regulators of all of the eligible Member States, who must jointly determine, within one month of receipt, which will be the Member State of reference for that non-EU AIFM. If the non-EU AIFM is not duly informed of the decision within seven days of the decision or if the decision is not made within the one-month period, the non-EU AIFM may choose its Member State of reference itself based on the criteria set out in Article 37(4).

B. Substitute compliance with non-EU law (Article 37(2))

1.168 In principle, the authorized non-EU AIFM must comply with all the provisions of the AIFMD. Article 37(2) permits relief if compliance with one or more provisions of the AIFMD is incompatible with compliance with the foreign law under which the non-EU AIFM and/or the non-EU AIF marketed in the EU is organized.

1.169 If the AIFM can demonstrate that the foreign law is mandatory, it is ‘impossible’ to comply with both the AIFMD and the foreign law, the foreign law provides for an ‘equivalent rule having the same regulatory purpose and offering the same level of protection to the investors of the relevant AIF’, and the non-EU AIFM and/or the non-EU AIF complies with the equivalent rule, the non-EU AIFM does not have to comply with that rule of the AIFMD.

1.170 Article 37(9) provides a procedure which must be followed by the Member State of reference where it considers that a non-EU AIFM is eligible for substitute compliance, which involves consultation with ESMA.

1.171 In the event of disagreement between the Member State of reference and another Member State that has an interest in the matter, the authority in question has the right to petition to ESMA, which may act in accordance with the powers conferred on it under the arbitration procedure provided by Article 19 of the ESMA Regulation.¹⁵⁰ Where the national regulators cannot reach agreement, ESMA may make a binding decision.¹⁵¹

1.172 Article 37(11) of the AIFMD provides that further business development by the non-EU AIFM in principle does not change the Member State of reference. However, in the event that the AIFM seeks to change its business plan within two years from the original determination of the Member State of reference such that it would affect that determination, the AIFM must notify the national regulator in the original Member State of reference of the intention before permitting the change to be implemented, indicating which Member State would be the Member State of reference if the change were implemented. It must then change its legal representative to a person in the new Member State of reference. The updating determination procedures are the same as the procedures that apply to the original determination, including consultation of ESMA.¹⁵²

1.173 After the two-year period, the AIFM has the option but not the obligation to re-determine its Member State of reference in case of a change of business plan.¹⁵³

¹⁵⁰ AIFMD, Art 37(9), final paragraph.

¹⁵¹ ESMA Regulation (n 29), Art 19(3).

¹⁵² AIFMD, Art 37(11).

¹⁵³ AIFMD, Art 37(12).

A competent regulator may initiate the procedure of Article 37(11) if the AIFM fails to do so following a change in its business.¹⁵⁴ 1.174

In the event of disagreement between the Member State of reference and another Member State that has an interest in the matter, the arbitration procedure in Article 19 of the ESMA Regulation applies.¹⁵⁵ 1.175

C. Passporting by non-EU AIFMs of management authorization (Article 41)

Article 41 of the AIFMD provides that an authorized non-EU AIFM may manage EU AIFs established in a Member State other than the non-EU AIFM's Member State of reference either directly or via the establishment of a branch, provided that the AIFM is authorized to manage that type of AIF. 1.176

Article 41 is the mirror image of Article 33, which gives the same rights to an EU AIFM who wishes to manage AIFs in a Member State other than the EU AIFM's home Member State. Accordingly, the notification procedure for authorized non-EU AIFMs under Article 41 is essentially identical to the notification procedure in Article 33 and discussed in paragraphs 1.151 to 1.156. 1.177

4. Application for authorization by EU and non-EU AIFMs

A. Information to be provided upon application (Article 7(2))

Article 7(1) of the AIFMD provides that an AIFM that seeks authorization must apply to the competent authority of its home Member State. Pursuant to Article 7(2), the application must include information about: 1.178

- (a) the persons effectively conducting the business of the AIFM;¹⁵⁶
- (b) the identities of the AIFM's shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings and the amounts of those holdings;¹⁵⁷
- (c) the business plan setting out the organizational structure of the AIFM,¹⁵⁸ including information on how the AIFM intends to comply with its key obligations under the AIFMD;¹⁵⁹

¹⁵⁴ AIFMD, Art 37(12).

¹⁵⁵ AIFMD, Art 37(12).

¹⁵⁶ AIFMD, Arts 7(2)(a) and 37(8).

¹⁵⁷ AIFMD, Art 7(2)(b). 'Qualifying holding' means a direct or indirect holding in an AIFM which represents 10% or more of the capital or of the voting rights, in accordance with Arts 9 and 10 of Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (OJ 2004 L390/38) ('Transparency Directive'), taking into account the conditions regarding aggregation of the holding laid down in Art 12(4) and (5) thereof, or which makes it possible to exercise a significant influence over the management of the AIFM in which that holding subsists (AIFMD, Art 4(1)(ah)). See, for similar provisions applying to UCITS management companies (but without any reference to the aggregation rules), UCITS Directive (n 2), Art 8(1), first paragraph and Art 2(1)(j). Compare also MiFID (n 14), Art 10(1), first paragraph.

¹⁵⁸ See, for similar requirements with respect to UCITS management companies and UCITS investment companies, UCITS Directive (n 2), Arts 7(1)(c) and 29(1)(a), respectively. Cf. also MiFID (n 14), Art 7(2) with respect to investment firms.

¹⁵⁹ AIFMD, Art 7(2)(c). It concerns: Chs II (authorization of AIFMs), III (operating conditions for AIFMs), IV (transparency requirements), and, where applicable, V (AIFMs managing specific types of AIF), VI (rights

- (d) the remuneration policies and practices; and
- (e) arrangements made for the delegation and sub-delegation to third parties of functions as referred to in Article 20 (delegation).¹⁶⁰

1.179 The application must also include information about the AIFs the AIFM intends to manage.¹⁶¹ It concerns information about:

- (a) the investment strategies, including the types of underlying funds if the AIF is a fund of funds, and the risk profiles and other characteristics of the AIFs it manages or intends to manage, including information about the Member States or third countries in which such AIFs are established or are expected to be established;¹⁶²
- (b) the location of the master AIF if the AIF is a feeder AIF;¹⁶³
- (c) the rules or instruments of incorporation of each AIF;¹⁶⁴
- (d) the arrangements made for the appointment of the depositary in accordance with Article 21 (depositary) for each AIF;¹⁶⁵ and
- (e) any additional information referred to in Article 23(1) (disclosure to investors) for each AIF the AIFM manages or intends to manage.¹⁶⁶

1.180 An application is deemed complete if the AIFM has submitted the information described in the previous paragraphs.¹⁶⁷

B. Additional rules for applications by non-EU AIFMs (Article 37(5) and (8))

1.181 Article 37(5) of the AIFMD provides that a non-EU AIFM that seeks authorization must apply to the competent authority of its Member State of reference. The provisions of Chapter II (Articles 6–11) apply *mutatis mutandis*,¹⁶⁸ provided that references to an AIFM's home Member State in those provisions are to be read as references to the applying non-EU AIFM's Member State of reference.¹⁶⁹

of EU AIFMs to market and manage EU AIFs in the Union), VII (specific rules in relation to third countries), and VIII (marketing to retail investors).

¹⁶⁰ AIFMD, Art 7(2).

¹⁶¹ By Art 37(8)(b), if the application is made by a non-EU AIFM, the information referred to in Art 7(3) may be limited to the EU AIFs the AIFM intends to manage and to those non-EU AIFs managed by the AIFM that it intends to market in the EU.

¹⁶² AIFMD, Art 7(3)(a).

¹⁶³ AIFMD, Art 7(3)(b). 'Feeder AIF' means an AIF which (i) invests at least 85% of its assets in units or shares of another AIF (the 'master AIF'); (ii) invests at least 85% of its assets in more than one master AIF where those master AIFs have identical investment strategies; or (iii) has otherwise an exposure of at least 85% of its assets to such a master AIF (Art 4(1)(m)). 'Master AIF' means an AIF in which another AIF invests or has an exposure in accordance with Art 4(1)(m) (Art 4(1)(y)).

¹⁶⁴ AIFMD, Art 7(3)(c).

¹⁶⁵ AIFMD, Art 7(3)(d).

¹⁶⁶ AIFMD, Art 7(3)(e).

¹⁶⁷ AIFMD, Art 8(5), second paragraph. A non-EU AIFM must also submit the information specified in Art 37(8)(a); see Art 37(8)(e).

¹⁶⁸ AIFMD, Art 37(8).

¹⁶⁹ See the definition of 'home member state' in AIFMD, Art 4(1)(q). Article 37(8)(c)–(e) provides for a few other logical variations of Art 8 as it applies to non-EU AIFMs, eg that the head office of the non-EU AIFM does not have to be in the EU.

In addition to the information required under Article 7(2), the non-EU AIFM must include the following information in its application:¹⁷⁰ **1.182**

- (a) a justification by the AIFM of its determination of the Member State of reference;
- (b) a list of the provisions of the AIFMD with which compliance is ‘impossible’ within the meaning of Article 37(2);¹⁷¹
- (c) written evidence in accordance with regulatory technical standards developed by ESMA that the law of the AIFM provides for a rule equivalent to the provisions for which compliance is impossible and that it has the same regulatory purpose and offers the same level of protection to the investors of the relevant AIFs and that the AIFM complies with that equivalent rule, supported by a legal opinion regarding the incompatible mandatory provision in the law of the AIFM that includes a description of its regulatory purpose and the nature of the investor protection afforded by it; and
- (d) the name and location of the legal representative of the AIFM.

The regulator who receives a request for authorization from a non-EU AIFM must decide whether the AIFM’s determination of its Member State of reference is correct. If the regulator disagrees, the application will be refused with reasons. If the regulator agrees with the AIFM, the regulator must seek advice from ESMA, which must do so within one month, during which the term in Article 8(5) is suspended.¹⁷² **1.183**

The non-EU AIFM must appoint a ‘legal representative’ in its Member State of reference, who will be responsible for liaison with the national regulator in the Member State of reference and the EU investors of the relevant AIF in relation to AIFMD-compliance matters. The legal representative, together with the AIFM, must perform the compliance function in respect of the management and marketing activities of the AIFM under the AIFMD.¹⁷³ **1.184**

C. If the applicant is a UCITS management company (Article 7(4))

A management company authorized under the UCITS Directive which seeks dual authorization does not have to provide information or documents which the UCITS management company has already provided when applying for authorization under the UCITS Directive, provided that such information or documents are up to date.¹⁷⁴ **1.185**

¹⁷⁰ AIFMD, Art 37(8)(a).

¹⁷¹ See paras 1.168–1.175.

¹⁷² AIFMD, Art 7(5).

¹⁷³ AIFMD, Art 37(2), (7)(b), (c).

¹⁷⁴ AIFMD, Art 7(4). In order to ensure consistent harmonization of the application for authorization, ESMA may develop draft regulatory technical standards to specify the information to be provided to the competent authorities in the AIFM’s application for the authorization, including the programme of activity (Art 7(6), first paragraph). Power is delegated to the Commission to adopt these regulatory technical standards in accordance with Arts 10–14 of the ESMA Regulation (n 29) (Art 7(6), second paragraph). Also, in order to ensure uniform conditions of application of authorization, ESMA may develop draft implementing technical standards to determine standard forms, templates, and procedures for the provision of information to the competent authorities in the AIFM’s application for the authorization (Art 7(7), first paragraph). Power is conferred on the Commission to adopt these implementing technical standards in accordance with Art 15 of the ESMA Regulation (n 29) (Art 7(7), second paragraph).

5. Conditions for granting authorization

A. General

- 1.186** The AIFM's national regulator must not authorize the AIFM unless it is satisfied that it will be able to meet the conditions of the AIFMD.¹⁷⁵ AIFMs authorized in accordance with the AIFMD must meet the conditions for authorization at all times, ie on an ongoing basis.¹⁷⁶

B. Management, shareholders/members, and head office (Article 8(1))

- 1.187** The persons who effectively conduct the business of the AIFM must be of sufficiently good repute and sufficiently experienced in relation to the investment strategies pursued by the AIFMs managed by the AIFM. The names of those persons and of every person succeeding them in office must be communicated to the competent authorities of the AIFM's home Member State. Conduct of business must be decided by at least two persons meeting these conditions (the 'four eyes' principle).¹⁷⁷
- 1.188** The shareholders or members of the AIFM that have qualifying holdings must be suitable, taking into account the need to ensure the sound and prudent management of the AIFM.¹⁷⁸ The head office and the registered office of the AIFM must be located in the same Member State.¹⁷⁹

C. Conditions relating to initial capital and own funds (Article 9)

- 1.189** The AIFMD requires AIFMs to have a minimum amount of initial capital and own funds. In addition, as an alternative to additional own funds, the AIFM may hold a professional indemnity insurance (PII) against liability arising from professional negligence.

¹⁷⁵ AIFMD, Art 8(1)(a). See, for a similar provision with respect to investment firms, MiFID (n 14), Art 7(1). Art 37(8)(c) of the AIFMD states that, in the case of an application by a non-EU AIFM, Art 8(1)(a) is without prejudice to Art 37(2), which provides for substitute compliance with the non-EU AIFM's law.

¹⁷⁶ AIFMD, Art 6(1), second paragraph.

¹⁷⁷ AIFMD, Art 8(1)(c). Similar requirements apply to UCITS management companies, UCITS investment companies, and investment firms: see UCITS Directive (n 2), Arts 7(1)(b), 29(1)(b) and MiFID (n 14), Art 9, respectively.

¹⁷⁸ AIFMD, Art 8(1)(d). 'Qualifying holding' means a direct or indirect holding in an AIFM which represents 10 % or more of the capital or of the voting rights, in accordance with Arts 9 and 10 of the Transparency Directive (n 157), taking into account the conditions regarding aggregation of the holding laid down in Art 12(4) and (5) thereof, or which makes it possible to exercise a significant influence over the management of the AIFM in which that holding subsists (AIFMD, Art 4(1)(ah)). See, for similar provisions applying to UCITS management companies (but without any reference to the aggregation rules), UCITS Directive (n 2), Art 8(1), second paragraph and Art 2(1)(j). Compare also MiFID (n 14), Art 10(1), second paragraph and Art 4(1), point 27. In order to ensure consistent harmonization of the conditions for granting authorization, ESMA may develop draft regulatory technical standards to specify the requirements applicable to shareholders and members with qualifying holdings (AIFMD, Art 8(6)(b)). Power is delegated to the Commission to adopt these regulatory technical standards in accordance with ESMA Regulation (n 29), Arts 10–14 (AIFMD, Art 8(6), second paragraph).

¹⁷⁹ AIFMD, Art 8(1)(e). Similar requirements apply to UCITS management companies and UCITS investment companies: see UCITS Directive (n 2), Arts 7(1)(d) and 27, third paragraph, respectively. By AIFMD, Art 37(8)(e), Art 8(1)(e) does not apply to applications made by non-EU AIFMs pursuant to Art 37(5).

An *internally* managed AIF must have an initial capital of at least EUR 300,000.¹⁸⁰ Where an AIFM is appointed as an *external* manager of AIFs, the AIFM must have an initial capital of at least EUR 125,000.¹⁸¹ **1.190**

If the value of the portfolios of AIFs managed by the AIFM exceeds EUR 250 million, the AIFM must provide an additional amount of own funds. That additional amount of own funds must be equal to 0.02% of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million but where the required total of the initial capital and the additional amount does not exceed EUR 10 million.¹⁸² **1.191**

Irrespective of the foregoing, own funds of the AIFM may never be less than the amount required under the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR).^{183, 184} Own funds, including any additional own funds, must be invested in liquid assets or assets readily convertible to cash in the short term and may not include speculative positions.¹⁸⁵ **1.192**

AIFs managed by the AIFM, including AIFs for which the AIFM has delegated portfolio or risk management functions,¹⁸⁶ but excluding AIF portfolios that the AIFM is managing under delegation, are deemed to be the portfolios of the AIFM.¹⁸⁷ **1.193**

Given the cap on variable capital requirements, if a firm manages multiple AIFs, it makes sense to concentrate the management of those AIFs in a single AIFM. Indeed, the industry would appear to be heading in the direction of ‘super AIFMs’ **1.194**

Member States may permit AIFMs to cover up to 50% of the variable capital with a guarantee from an EU credit institution or insurance undertaking. A non-EU institution is also **1.195**

¹⁸⁰ AIFMD, Art 9(1). The same amount applies to UCITS investment companies: see UCITS Directive (n 2), Art 29(1).

¹⁸¹ AIFMD, Art 9(2). The same amount applies to UCITS management companies: see UCITS Directive (n 2), Art 7(1)(a).

¹⁸² AIFMD, Art 9(3). The same rules apply to UCITS management companies: see UCITS Directive (n 2), Art 7(1)(a)(i).

¹⁸³ (1) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ 2013 L176/338) and (2) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ 2013 L176/1).

¹⁸⁴ AIFMD, Art 9(5). The same rule applies with respect to UCITS management companies: see UCITS Directive (n 2), Art 7(1)(a)(iii). In the AIFMD (and also in the UCITS Directive (n 2) and MiFID (n 14)), reference is made to Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) (OJ 2006 L177/201) (or, in the case of MiFID (n 14), even to Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (OJ 1993 L141/1)), but according to recital (98) of CRD IV (para 1.192) these references should be construed as references to the provisions governing own funds requirements in CRD IV and CRR (in the case of MiFID (n 14) this should be read in conjunction with Directive 2006/49/EC, Art 5).

¹⁸⁵ AIFMD, Art 9(8).

¹⁸⁶ See AIFMD, Art 20 (delegation). Note that the restrictions set out in Art 20 only apply to delegation of portfolio and risk management functions, not to any additional functions an AIFM may perform in the course of the collective management of an AIF. See recital (31).

¹⁸⁷ AIFMD, Art 9(4). The same rule applies to UCITS management companies: see UCITS Directive (n 2), Art 7(1)(a)(ii).

eligible if it is subject to prudential rules considered by the competent authorities as equivalent to EU law.¹⁸⁸

D. Cover for professional negligence liability (Article 9(7))

- 1.196** AIFMs must have appropriate cover for professional liability arising from negligence in connection with the management of AIFs by a relevant person¹⁸⁹ for which the AIFM has legal responsibility.¹⁹⁰ The cover may be provided either by way of an appropriate amount of additional own funds¹⁹¹ or by way of a professional indemnity insurance.¹⁹²

E. Exemption from capital rules for UCITS management company (Article 9(7))

- 1.197** With the exception of the requirements on coverage of potential professional liability risks and the requirement that own funds must be invested in liquid assets, the rules on initial capital and own funds do not apply to AIFMs that are also UCITS management companies.¹⁹³ These requirements already apply to UCITS management companies under the UCITS Directive.

6. Procedural aspects

A. Consultation of authorities in other Member States

- 1.198** Where a subsidiary of (the parent undertaking of) an AIFM, a UCITS management company, an investment firm, a credit institution, or an insurance undertaking is authorized in another Member State, the national regulators of that other state must be consulted before authorization is granted.
- 1.199** The national regulator of another Member State must also be consulted before authorization is granted to: a company controlled by the same natural or legal persons as those that control an AIFM, a UCITS management company, an investment firm, a credit institution, or an insurance undertaking; g, if any of these entities is authorized in that other Member State.¹⁹⁴

¹⁸⁸ AIFMD, Art 9(6). The same rule applies to UCITS management companies: see UCITS Directive (n 2), Art 7(1), *in fine*.

¹⁸⁹ For the purpose of professional liability, 'relevant person' means any of the following: (a) a director, partner or equivalent, or manager of the AIFM; (b) an employee of the AIFM, or any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the provision of collective portfolio management services by the AIFM; (c) a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM (Implementing Regulation, Art 1(2)).

¹⁹⁰ Implementing Regulation, Art 12(1), made by the Commission pursuant to AIFMD, Art 9(9)(a). See, for a further specification of professional liability risks, Implementing Regulation, Art 12(2), (3).

¹⁹¹ AIFMD, Art 9(7), first sentence, and (a). See Implementing Regulation, Arts 13, 14, made by the Commission pursuant to AIFMD, Art 9(9)(b), (c), for a further specification of this requirement.

¹⁹² AIFMD, Art 9(7), opening words, and (b). See Implementing Regulation, Arts 13, 15 (based on AIFMD, Art 9(9)(b), (c)) for a further specification of this requirement. See also G. Walker, 'The Liability Insurance of the AIFM', in Zetzsche, *The Alternative Investment Fund Managers Directive* (Kluwer Law International, 2012) (n 21) 199 et seq.

¹⁹³ AIFMD, Art 9(10).

¹⁹⁴ AIFMD, Art 8(2). See, for a similar provision with respect to UCITS management companies, UCITS Directive (n 2), Art 8(3).

B. Term for granting authorization (Article 8(5))

The competent authorities of the AIFM's home Member State must inform the applicant in writing within three months of the submission of a complete application, whether or not authorization has been granted. The competent authorities may prolong this period for up to three additional months where they consider it necessary due to the specific circumstances of the case and after having notified the AIFM accordingly.¹⁹⁵ **1.200**

C. Rejection of an application (Article 8(3))

Authorization must be refused if the effective exercise of their supervisory functions is prevented by close links between the AIFM and other natural or legal persons,¹⁹⁶ the laws, regulations, or administrative provisions of a third country governing natural or legal persons with which the AIFM has close links,¹⁹⁷ or difficulties involved in the enforcement of those laws, regulations, and administrative provisions.¹⁹⁸ **1.201**

D. Restriction of authorization (Article 8(3))

The scope of the authorization may be restricted, in particular in relation to the range of investment strategies of AIFs the AIFM has permission to manage.¹⁹⁹ **1.202**

E. Disagreement about authorization of a non-EU AIFM (Article 37(8))

If a competent national regulator disagrees with the authorization granted by the competent regulator of a non-EU AIFM's Member State of reference, the regulator has the right to petition to ESMA, which may act in accordance with the powers conferred on it under ESMA Regulation, Article 19.²⁰⁰ **1.203**

Article 19 of the ESMA Regulation provides for an arbitration procedure. Where the national regulators cannot reach agreement, ESMA may make a binding decision.²⁰¹ **1.204**

¹⁹⁵ AIFMD, Art 8(5), first paragraph. In the case of authorization pursuant to the UCITS Directive (n 2), the terms for granting authorization are different: the UCITS management company or, where applicable, the UCITS investment company, must be informed within two months (without any possibility of prolongation) of the submission of a complete application, whether or not authorization of the UCITS has been granted (UCITS Directive (n 2), Art 5(4), second paragraph). However, where a UCITS investment company has not designated a UCITS management company, the investment company must be informed, within six months of the submission of a complete application, whether or not authorization has been granted (UCITS Directive (n 2), Art 29(2)). In the case of authorization of investment firms, an applicant must be informed within six months of the submission of a complete application, whether or not authorization has been granted (MiFID (n 14), Art 7(3)).

¹⁹⁶ AIFMD, Art 8(3)(a). Similar provisions apply to UCITS management companies, UCITS investment companies, and investment firms: see UCITS Directive (n 2), Art 7(2), first paragraph, Art 29(1)(c), first paragraph, and MiFID (n 14), Art 10(1), third paragraph, respectively.

¹⁹⁷ AIFMD, Art 8(3)(b). Similar provisions apply to UCITS management companies, UCITS investment companies, and investment firms: see UCITS Directive (n 2), Art 7(2), second paragraph, Art 29(1)(c), second paragraph, and MiFID (n 14), Art 10(2), first part, respectively.

¹⁹⁸ AIFMD, Art 8(3)(c). Similar provisions apply to UCITS management companies, UCITS investment companies, and investment firms: see UCITS Directive (n 2), Art 7(2), second paragraph, Art 29(1)(c), second paragraph, and MiFID (n 14), Art 10(2), second part, respectively. In order to ensure consistent harmonization of the conditions for granting authorization, ESMA may develop draft regulatory technical standards to specify the grounds for refusal (AIFMD, Art 8(6)(a)). Art 8(6)(c) seems merely to repeat Art 8(6)(a), but the status of Art 8(6)(c) is not entirely clear. Power is delegated to the Commission to adopt these regulatory technical standards in accordance with ESMA Regulation (n 29), Arts 10–14: AIFMD, Art 8(6), second paragraph.

¹⁹⁹ AIFMD, Art 8(4).

²⁰⁰ AIFMD, Art 37(8), final paragraph.

²⁰¹ ESMA Regulation (n 29), Art 19(3).

F. Authorization effective (Article 8(5))

- 1.205** AIFMs may engage in the business of managing an AIF with investment strategies described in the application as soon as the authorization is granted, but not earlier than one month after submitting any missing information about: (i) (sub-)delegation arrangements, (ii) the rules or instruments of incorporation of each AIF the AIFM intends to manage, (iii) depositary arrangements, and (iv) disclosure to investors with respect to each AIF the AIFM manages or intends to manage.²⁰²

G. Changes in the scope of the authorization (Article 10)

- 1.206** Before implementation, AIFMs must notify the competent authorities of their home Member State of any material changes to the conditions for initial authorization, in particular material changes to the information provided in accordance with Article 7 (application for authorization) AIFMD.²⁰³
- 1.207** If the competent authorities of the home Member State impose restrictions or reject those changes, they must, within one month of receipt of that notification, inform the AIFM. The competent authorities may prolong that period for up to one month, where they consider this necessary because of the specific circumstances of the case and after having notified the AIFM accordingly. The changes must be implemented if the competent authorities do not oppose the changes within the relevant assessment period.²⁰⁴

H. Withdrawal of authorization (Article 11)

- 1.208** The authorization may be withdrawn if the AIFM:
- (a) does not make use of the authorization within 12 months, expressly renounces the authorization, or has ceased the activity covered by the AIFMD for the preceding six months, unless the Member State has provided for authorization to lapse in such cases;²⁰⁵
 - (b) obtained the authorization by making false statements or by any other irregular means;²⁰⁶
 - (c) no longer meets the conditions under which authorization was granted;²⁰⁷
 - (d) no longer complies with CRD IV and CRR if its authority also covers the MiFID service of individual portfolio management;²⁰⁸
 - (e) has seriously or systematically infringed the provisions adopted pursuant to the AIFMD.²⁰⁹

²⁰² AIFMD, Art 8(5), third paragraph.

²⁰³ AIFMD, Art 10(1).

²⁰⁴ AIFMD, Art 10(2).

²⁰⁵ AIFMD, Art 11(a). See, in a similar vein with respect to UCITS management companies, UCITS investment companies, and investment firms, UCITS Directive (n 2), Arts 7(5)(a), 29(4)(a), and MiFID (n 14), Art 8(a), respectively.

²⁰⁶ AIFMD, Art 11(b). Compare, in relation to UCITS management companies, UCITS investment companies, and investment firms, UCITS Directive (n 2), Arts 7(5)(b), 29(4)(b), and MiFID (n 14), Art 8(b), respectively.

²⁰⁷ AIFMD, Art 11(c). Compare, in relation to UCITS management companies, UCITS investment companies, and investment firms, UCITS Directive (n 2), Arts 7(5)(c), 29(4)(c), and MiFID (n 14), Art 8(c), respectively.

²⁰⁸ AIFMD, Art 11(d). Compare, in relation to UCITS management companies and investment firms, UCITS Directive (n 2), Art 7(5)(d) and MiFID (n 14), Art 8(c), *in fine*. See nn 183 and 184.

²⁰⁹ AIFMD, Art 11(e). Compare, in relation to UCITS management companies, UCITS investment companies, and investment firms, UCITS Directive (n 2), Arts 7(5)(e), 29(4)(d), and MiFID (n 14), Art 8(d), respectively.

- (f) falls within any of the cases where national law, in respect of matters outside the scope of the AIFMD, provides for withdrawal.²¹⁰

I. Central public register (Articles 7(5) and 37(10))

Each national regulator must, on a quarterly basis, inform ESMA of authorizations granted or withdrawn in accordance with Chapter III (authorization of AIFMs) of the AIFMD.²¹¹ ESMA must keep a central public register identifying each AIFM authorized under the AIFMD, a list of the AIFs managed and/or marketed in the European Union by such AIFMs, and the competent authority for each such AIFM. The register must be made available in electronic format.²¹² **1.209**

IV. Operating Requirements

1. Overview

The general operation conditions for AIFMs draw heavily on those established in the MiFID and the UCITS Directive. The AIFMD aims to strike a balance between a level of consistency with those Directives, while taking into account the diversity of AIFs and the different types of assets they invest in.²¹³ **1.210**

Existing MiFID firms and UCITS management companies that consider they will be AIFMs should be aware of several new general principles, including additional due diligence responsibilities, requirements relating to the appointment of counterparties and prime brokers, and the introduction of a fair treatment definition.²¹⁴ **1.211**

2. General Principles (Article 12)

A. General

AIFMs must at all times: **1.212**

- (a) act honestly, with due skill, care, and diligence and fairly in conducting their activities;
- (b) act in the best interests of the AIFs or the investors of the AIFs²¹⁵ they manage and the integrity of the market;²¹⁶

²¹⁰ AIFMD, Art 11(f). Compare, in relation to UCITS management companies, UCITS investment companies, and investment firms, UCITS Directive (n 2), Arts 7(5)(f), 29(4)(e), and MiFID (n 14), Art 8(e), respectively.

²¹¹ AIFMD, Art 7(5), first paragraph.

²¹² AIFMD, Art 7(5), second paragraph. See Art 37(10) in relation to non-EU AIFMs. Compare MiFID (n 14), Art 5(3) which provides that the Member States, not ESMA, must establish a register of all investment firms.

²¹³ ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (November 2011) (ESMA Advice (November 2011)) 39–40; FSA, Discussion Paper DP 12/1, 'Implementation of the Alternative Investment Fund Managers Directive' (January 2012) (DP 12/1 (January 2012)) 28, paras 4.1, 4.2.

²¹⁴ Cf. FSA, DP 12/1 (n 213) 29, para 4.5.

²¹⁵ The best interests of the investors refers to the investors' interests in their specific capacity as investors of the AIF, and not their individual interests. See AIFMD, recital (12).

²¹⁶ AIFMD, Art 12(1)(a), (b). See, for comparable provisions with respect to UCITS management companies and investment firms, UCITS Directive (n 2), Art 14(1)(a), (b) and MiFID (n 14), Arts 19(1) and 25(1), respectively.

- (c) have and employ effective resources and procedures that are necessary for the proper performance of their business activities;²¹⁷
- (d) take all reasonable steps to avoid, identify, manage, monitor, and disclose conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated;²¹⁸
- (e) comply with all regulatory requirements applicable to the conduct of their business activities so as to promote the best interests of the AIFs or the investors of the AIFs and the integrity of the market;²¹⁹ and
- (f) treat all AIF investors fairly.²²⁰

1.213 The duties set out under (a)–(f) will collectively be referred to as ‘duty of care and diligence’.

1.214 When assessing the compliance of the AIFM with the duty of care and diligence set out in paragraphs 1.212 and 1.213, the competent authorities must use *at least* the criteria laid down in Chapter III (operating conditions for AIFMs), section 1 (general principles) of the Implementing Regulation.²²¹ ‘At least’ means that these criteria are minimum standards and do not intend to provide maximum harmonization. Member States may impose additional requirements.

B. Acting in the best interest of the AIF or the AIF’s investors and the integrity of the market

1.215 In order to act in the best interest of the AIF or its investors and the integrity of the market, AIFMs must apply policies and procedures for preventing malpractices, including those that might reasonably be expected to adversely affect the stability and integrity of the market, such as market timing and late trading.²²²

1.216 AIFMs must also ensure that the AIFs they manage or the investors in the AIFs are not charged undue costs.²²³

C. Due diligence

a. General

1.217 AIFMs must: (i) apply a high standard of diligence in the selection and ongoing monitoring of investments;²²⁴ (ii) ensure that they have adequate knowledge and understanding of the

²¹⁷ AIFMD, Art 12(1)(c). See, for a similar provision, UCITS Directive (n 2), Art 14(1)(c).

²¹⁸ AIFMD, Art 12(1)(d). The conflicts of interest duties are further elaborated in AIFMD, Art 14 and Implementing Regulation, Arts 30–37. See, for a treatment of these rules, paras 1.268–1.281. See, for a similar but less detailed provision, UCITS Directive (n 2) Art 14(1)(d). See also MiFID (n 14), Art 13(3).

²¹⁹ AIFMD, Art 12(1)(e). See, for a similar provision, UCITS Directive (n 2), Art 14(1)(e).

²²⁰ AIFMD, Art 12(1)(f). See, for a similar provision, 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 (OJ 2010 L176/42) (‘UCITS Implementing Directive’), Art 22(1), first paragraph. However, fair treatment duty for UCITS management companies is much stricter than for AIFMs; see further n 234.

²²¹ Implementing Regulation, Art 16. See, for the legal basis of the implementation rules set out in Implementing Regulation, Ch III, section 1s, AIFMD, Art 12(3), providing that the Commission must adopt, by means of delegated acts in accordance with Art 56 and subject to the conditions of Arts 57 and 58, measures specifying the criteria to be used by the relevant competent authorities to assess whether AIFMs comply with their obligations set out in Art 12(1).

²²² Implementing Regulation, Art 17(1) and recital (39). See, for a similar provision with respect to UCITS management companies, UCITS Implementing Directive (n 220), Art 22(2), which is, however, restricted to preventing malpractices that might reasonably be expected to affect the stability and integrity of the market.

²²³ Implementing Regulation, Art 17(2). See for a similar provision UCITS Implementing Directive (n 220), Art 22(4).

²²⁴ Implementing Regulation, Art 18(1). See, for a similar provision, UCITS Implementing Directive (n 220), Art 23(1).

assets in which the AIF is invested;²²⁵ and (iii) establish, implement, apply, and regularly review and update written policies and procedures on due diligence and implementing effective arrangements for ensuring that investment decisions on behalf of the AIFs are carried out in compliance with the objectives, investment strategy, and, where applicable, risk limits of the AIF.²²⁶

b. Illiquid assets

Where AIFMs invest in assets of limited liquidity and such investment is preceded by a negotiation phase, the AIFM must, in relation to the negotiation phase, in addition to the requirements in paragraph 1.217: **1.218**

- (a) set out and regularly update a business plan consistent with the duration of the AIF and market conditions, seek and select possible transactions consistent with such business plan, and monitor the performance of the AIF with respect to such business plan;
- (b) assess the selected transactions in consideration of opportunities, if any, and overall related risks, all relevant legal, tax-related, financial, or other value affecting factors, human and material resources, and strategies, including exit strategies, and
- (c) perform due diligence activities related to the transactions prior to financing execution. AIFMs must retain records of these activities for at least five years.²²⁷

D. Requirements to governing body and personnel AIFM

In order to establish whether an AIFM conducts its activities honestly, fairly, and with due skills, the competent authorities must assess, *at least*, (ie no maximum harmonization is intended), whether the following conditions are met: **1.219**

- (a) The governing body of the AIFM must possess adequate collective knowledge, skills, and experience to understand the AIFM's activities, in particular the main risks involved in those activities and the assets in which the relevant AIF invests.
- (b) In line with the Commission's Green Paper on corporate governance in the financial sector,²²⁸ the members of the governing body must commit sufficient time to properly perform their functions in the AIFM.
- (c) Each member of the governing body must act with honesty, integrity, and independence of mind.
- (d) The AIFM must devote adequate resources to the induction and training of members of the governing body.²²⁹

Similar requirements are currently²³⁰ not in place for UCITS management companies and investment firms.

²²⁵ Implementing Regulation, Art 18(2). See, for a similar provision, UCITS Implementing Directive (n 220), Art 23(2).

²²⁶ Implementing Regulation, Art 18(3), (4). See, for a similar provision, UCITS Implementing Directive (n 220), Art 23(3), but without any explicit obligation to regularly review and update the written due diligence policies and procedures.

²²⁷ Implementing Regulation, Art 19. Similar provisions do not apply to UCITS management companies. This is explained by the fact that UCITS investment companies are as a general rule obliged to invest in liquid assets: see UCITS Directive (n 2), Ch VII.

²²⁸ COM(2010) 284. See Implementing Regulation, recital (42).

²²⁹ Implementing Regulation, Art 21.

²³⁰ Note that Art 9 (management body) of the European Commission's MiFID II proposal (n 117) provides similar conditions. In addition, it seems likely that in the future similar conditions will apply to UCITS management companies. There seems to be no good reason in principle why similar provisions should not apply to UCITS management companies.

1.220 AIFMs must employ sufficient personnel with the skills, knowledge, and expertise necessary for discharging the responsibilities allocated to them. For this purpose, AIFMs must take into account the nature, scale, and complexity of their business and the nature and range of services and activities undertaken in the course of that business.²³¹ Similar requirements are not in place for UCITS management companies and investment firms.

E. Fair treatment of investors in the AIF

1.221 AIFMs must treat all AIF investors fairly.²³² An AIFM must ensure that its decision-making procedures and organizational structure ensure fair treatment of investors.²³³ No investor in an AIF may obtain preferential treatment unless such treatment is disclosed in the relevant AIFs rules or instruments of incorporation. However, the preferential treatment accorded by an AIFM to one or more investors cannot result in an overall material disadvantage to other investors.²³⁴

1.222 In its advice to the Commission, ESMA recognizes 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 maximum harmonizing definition of what fair treatment means in practice. ESMA's approach recognizes that most national regulatory frameworks contain a principle of fair treatment, and that introducing a strict definition may prevent competent authorities from taking the necessary steps to prevent customer detriment where it is evident from the circumstances of a particular case that an investor has not been treated fairly.

1.223 ESMA's approach to fair treatment is based on the underlying principle that investors should be treated equally. No investor should obtain preferential treatment causing an overall material disadvantage to other investors. However, it is recognized that fair treatment does not prevent AIFMs from treating certain customers differently, such as 'seed' investors having better terms than those who invest later.²³⁵ Also, it does not appear that equal treatment means equal financial treatment. Pricing differentiation ought to be permitted, as long as it does not prejudice other investors' interests.

F. Inducements

1.224 AIFMs are not regarded as acting honestly, fairly, and in accordance with the best interests of the AIFs they manage or the investors in these AIFs if they do not comply with the inducement rules.²³⁶

1.225 An AIFM may not give or receive inducements (whether in the form of a fee, commission, or any non-monetary benefit) in relation to the performance of AIFMD services except where:

- (i) the inducement is paid to or received from the AIF or a person acting on behalf of the AIF;

²³¹ Implementing Regulation, Art 22.

²³² AIFMD, Art 12(1)(f). See, for a similar provision, UCITS Implementing Directive (n 220), Art 22(1), first paragraph.

²³³ Implementing Regulation, Art 23(1).

²³⁴ AIFMD, Art 12(1), last sentence and Implementing Regulation, Art 23(2). The UCITS Implementing Directive (n 220) takes a much stricter stance: UCITS management companies must refrain from placing the interests of any group of unit-holders above the interests of any other group of unit-holders: UCITS Implementing Directive (n 220), Art 22(1), second paragraph. This different approach may be explained by the fact that UCITSs are designed as retail products and AIFs as wholesale products.

²³⁵ ESMA Advice (n 213) 51; FSA, DP 12/1 (n 213) 30, paras 4.12, 4.13.

²³⁶ Implementing Regulation, Art 24(1).

- (ii) an inducement paid to or received from a third party or a person acting on his behalf is disclosed in full, is designed to enhance the quality of the relevant service, and does not impair compliance with the AIFM's duty to act in the best interests of its AIF or the investors of the AIF;
- (iii) where proper third party fees enable or are necessary for the provision of the relevant service and cannot, by their nature, give rise to conflicts with the AIFM's duties to act honestly, fairly, and in accordance with the best interests of the AIF or the investors of the AIF.²³⁷

G. Best execution

a. Execution of decisions and orders in financial instruments

AIFMs must act in the best interests of their AIFs or investors of the AIFs they manage when executing decisions to deal on behalf of the AIFs in the context of the management of their portfolio.²³⁸ **1.226**

Recital (45) of the Implementing Regulation observes that investors in AIFs should benefit from protection similar to that of AIFM clients to whom AIFMs provide the MiFID service of individual portfolio management, but that notwithstanding, the differences between the various types of assets in which AIFs are invested should be taken into account, since best execution is not relevant, for instance, when the AIFM invests in real estate or partnership interests and the investment is made after extensive negotiations on the terms of the agreement. **1.227**

Whenever AIFMs buy or sell financial instruments or other assets for which best execution is relevant, they must take all reasonable steps to obtain the best possible result for their AIFs or investors, taking into account (i) price, (ii) costs, (iii) speed, (iv) likelihood of execution and settlement, (v) size, (vi) nature, or (vii) any other consideration relevant to the execution of the order ('best execution').²³⁹ **1.228**

With a view to complying with the best execution rules, AIFMs must establish and implement effective arrangements. In particular, they must establish in writing and implement an **1.229**

²³⁷ These rules are currently the same for UCITS management companies and investment companies: see UCITS Implementing Directive (n 220), Art 29 and Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (OJ 2006 L241/26) ('MiFID Implementing Directive'), Art 26, respectively. However, Art 24(5) and (6) of the European Commission's MiFID II proposal (n 117) provides for a further tightening of the inducement rules for investment firms. The proposal intends to ban third party inducements completely in relation to investment firms providing investment advice on an independent basis and those providing individual portfolio management (note that this aspect of the MiFID II proposal is a moving target).

²³⁸ Implementing Regulation, Art 27(1). See, for a similar provision, UCITS Implementing Directive (n 220), Art 25(1). Whenever there is no choice of different execution venues, AIFMs are only subject to Implementing Regulation, Art 27(1), not Art 27(2)–(5). However, AIFMs must be able to demonstrate that there is no choice of different execution venues. See Implementing Regulation, Art 27(7).

²³⁹ Implementing Regulation, Art 27(2). See, for similar provisions with respect to UCITS management companies and investment firms, UCITS Implementing Directive (n 220), Art 25(2) and MiFID (n 14), Art 21(1), respectively. The relative importance of such factors must be determined by reference to the following criteria: (i) the objectives, investment policy, and risks specific to the AIF, as indicated in its rules or articles of association, prospectus, or offering documents; (ii) the characteristics of the order; (iii) the characteristics of the financial instruments or other assets that are the subject of that order; and (iv) the characteristics of the execution venues to which that order can be directed (Implementing Regulation, Art 27(2)(a)–(d); see, for similar provisions, UCITS Implementing Directive (n 220), Art 25(2)(a)–(d) and MiFID Implementing Directive (n 237), Art 44(1)).

execution policy to allow AIFs and their investors to obtain, for AIF orders, best execution.²⁴⁰ AIFMs must be able to demonstrate that they have executed orders on behalf of the AIF in accordance with their execution policy.²⁴¹

- 1.230** Recitals (45) and (46) of the Implementing Regulation clarify that best execution and order handling obligations will not apply where there has been an extensive negotiation of the terms of a particular investment (eg in real estate, partnership interests, or (in respect of order handling obligations) non-listed companies).

b. Placing orders in financial instruments and other assets with third parties

- 1.231** Similar best execution rules apply when an AIFM does not execute orders on behalf of managed AIFs itself, but instead places them with third parties. When doing so, the AIFM must act in the best interest of its AIFs or their investors.²⁴² AIFMs must take reasonable steps to obtain best execution, taking into account the factors that also apply to AIFMs executing orders themselves (see paragraphs 1.226 to 1.230).²⁴³
- 1.232** With a view to complying with the best execution rules, AIFMs must establish, implement, and apply an order-placing policy to enable them to comply with the best execution rules. The order-placing policy must identify, in respect of each class of instruments, the entities with which the orders may be placed. An AIFM may only enter into arrangements for execution where such arrangements are consistent with the best execution rules.
- 1.233** The AIFM must make appropriate information on the order-placing policy, including any material changes to the policy available to the investors in its AIFs.²⁴⁴ AIFMs must be able to demonstrate that they have placed orders on behalf of the AIF in accordance with the order-placing policy.²⁴⁵

²⁴⁰ Implementing Regulation, Art 27(3). See, for similar provisions, UCITS Implementing Directive (n 220), Art 25(3) and MiFID (n 14), Art 21(2).

²⁴¹ Implementing Regulation, Art 27(6). See, for similar provisions, UCITS Implementing Directive (n 220), Art 25(5) and MiFID (n 14), Art 21(5). Furthermore, AIFMs must: (i) monitor on a regular basis the effectiveness of their arrangements and policy for the execution of orders with a view to identifying and, where appropriate, correcting any deficiencies; and (ii) review the execution policy on an annual basis, but this should also be carried out whenever a material change occurs that affects the AIFM's ability to continue to obtain the best possible result for the managed AIFs (Implementing Regulation, Art 27(4), (5); see, for similar provisions, UCITS Implementing Directive (n 220), Art 25(4) and MiFID (n 14), Art 21(4)).

²⁴² Implementing Regulation, Art 28(1). See, for similar provisions, UCITS Implementing Directive (n 220), Art 26(1) and Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive (OJ 2006 L 241/1) ('MiFID Implementation Regulation'), Art 45(1), (2). Whenever there is no choice of different execution venues, AIFMs are only subject to Art 28(1), not Art 28(2)–(4). However, in such a case AIFMs must be able to demonstrate that there is no choice of different execution venues. See Implementing Regulation, Art 28(5).

²⁴³ Implementing Regulation, Art 28(2), first paragraph. See, for similar provisions, UCITS Implementing Directive (n 220), Art 26(2), first paragraph and MiFID Implementing Directive (n 237), Art 45(4), first paragraph.

²⁴⁴ Implementing Regulation, Art 28(2), second paragraph. See, for similar provisions, UCITS Implementing Directive (n 220), Art 26(2), second paragraph and MiFID Implementing Directive (n 237), Art 45(5).

²⁴⁵ Implementing Regulation, Art 28(4). See, for a similar provision, UCITS Implementing Directive (n 220), Art 26(4). Furthermore, AIFMs must: (i) monitor on a regular basis the effectiveness of the order-placing policy and, in particular, the quality of the execution by the entities identified in that order-placing policy and, where appropriate, correct any deficiencies; (ii) review the order-placing policy on an annual basis, but this should also be carried out whenever a material change occurs that affects the AIFM's ability to continue to obtain best execution for the managed AIFs (Implementing Regulation, Art 28(3); see, for similar provisions, UCITS Implementing Directive (n 220), Art 26(2) and MiFID (n 14), Art 45(6)).

H. Order handling

a. General principles

AIFMs must establish, implement, and apply procedures and arrangements which provide for the prompt, fair, and expeditious execution of orders on behalf of the AIF.²⁴⁶ These procedures and arrangements must (i) ensure that orders executed on behalf of AIFs are promptly and accurately recorded and allocated²⁴⁷ and (ii) be executed sequentially and promptly unless the characteristics of the order or the prevailing market conditions make this impracticable, or the interests of the AIF or its investors require otherwise.²⁴⁸ **1.234**

The financial instruments, sums of money, or other assets, received in settlement of the executed orders must be promptly and correctly delivered to or registered in the account of the relevant AIF.²⁴⁹ **1.235**

An AIFM may not misuse information related to pending orders (ie front-running) and must take all reasonable steps to prevent the misuse of such information by any of its relevant persons.^{250, 251} **1.236**

The AIFMD order-handling rules correspond to those in MiFID and the UCITS Directive for reasons of consistency. The rules should not apply where the investment in assets is made after extensive negotiations on the terms of the agreement, such as investment in real estate, partnership interests, or non-listed companies, as in such cases the order is executed.²⁵² **1.237**

b. Aggregation and allocation of orders

AIFMs may only carry out an AIF order in aggregate with an order of another AIF, a UCITS, or a client or with an order made when investing their own funds, where (i) it can be reasonably expected that the aggregation of orders will not work overall to the disadvantage of any AIF, UCITS, or clients whose order is to be aggregated²⁵³ and (ii) an order allocation policy is established and implemented, providing in sufficiently precise terms for the fair allocation **1.238**

²⁴⁶ Implementing Regulation, Art 25(1). See, for similar provisions with respect to UCITS management companies and investment firms, UCITS Implementing Directive (n 220), Art 27(1), first paragraph and MiFID (n 14), Art 22(1), first paragraph.

²⁴⁷ Implementing Regulation, Art 25(2)(a). See, for similar provisions with respect to UCITS management companies and investment firms, UCITS Implementing Directive (n 220), Art 27(1)(a), second paragraph and MiFID (n 14), Art 22(1), first paragraph, respectively.

²⁴⁸ Implementing Regulation, Art 25(2)(b). See, for similar provisions with respect to UCITS management companies and investment firms, UCITS Implementing Directive (n 220), Art 27(1)(b), second paragraph and MiFID (n 14), Art 22(1), second paragraph, read in conjunction with MiFID Implementing Directive (n 237), Art 47(1)(b), respectively.

²⁴⁹ Implementing Regulation, Art 25(3). See, for similar provisions with respect to UCITS management companies and investment firms, UCITS Implementing Directive (n 220), Art 27(1), third paragraph and MiFID Implementing Directive (n 237), Art 47(1)(a), read in conjunction with Art 47(2), respectively.

²⁵⁰ 'Relevant person' means any of the following: (a) a director, partner, or equivalent, or manager of the AIFM; (b) an employee of the AIFM, or any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the provision of collective portfolio management services by the AIFM; (c) a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM (Implementing Regulation, Art 1(2)).

²⁵¹ Implementing Regulation, Art 25(4). See, for similar provisions with respect to UCITS management companies and investment firms, UCITS Implementing Directive (n 220), Art 27(2) and MiFID Implementing Directive (n 237), Art 47(3).

²⁵² Implementing Regulation, recital (46).

²⁵³ Implementing Regulation, Art 29(a). See, for similar provisions, UCITS Implementation Directive, Art 28(1)(a) and MiFID Implementing Directive (n 237), Art 48(1)(a).

of aggregated orders, including how the volume and price of orders determines allocations and the treatment of partial executions.²⁵⁴

- 1.239** If an AIFM is allowed to aggregate an AIF order with one or more orders of other AIFs, UCITSs, or clients and the aggregated order is partially executed, it must allocate the related trades in accordance with its order allocation policy.²⁵⁵
- 1.240** When transactions for the account of the AIF itself are involved, the following rules apply. First, the AIFM, which has aggregated transactions for its own account with one or more orders of AIFs, UCITSs, or clients, may not allocate the related trades in a way that is detrimental to the AIF, UCITS, or client.²⁵⁶
- 1.241** Second, where an AIFM aggregates an order of an AIF, UCITS, or another client with a transaction for its own account and the aggregated order is partially executed, it must allocate the related trades to the AIF, UCITS, or client in priority to those for its own account.²⁵⁷
- 1.242** However, if the AIFM is able to demonstrate to the AIF or client on reasonable grounds that it would not have been able to carry out the order on such advantageous terms without aggregation, or at all, it may allocate the transaction for its own account proportionally, in accordance with its order allocation policy.²⁵⁸

I. Execution of subscription and redemption orders

- 1.243** Where AIFMs have carried out a subscription or a redemption order from an investor, they must promptly provide the investor, by means of a durable medium, with the essential information²⁵⁹ concerning the execution of that order or the acceptance of the subscription offer, as the case may be.²⁶⁰
- 1.244** AIFMs must supply the investor, upon request, with information about the status of the order or the acceptance of the subscription offer, or both, as the case may be.²⁶¹

²⁵⁴ Implementing Regulation, Art 29(b). See, for similar provisions, UCITS Implementation Directive (n 220), Art 28(1)(b) and MiFID Implementing Directive (n 237), Art 48(1)(c).

²⁵⁵ Implementing Regulation, Art 29(2). See, for similar provisions, UCITS Implementing Directive (n 220), Art 30(2) and MiFID Implementing Directive (n 237), Art 48(2).

²⁵⁶ Implementing Regulation, Art 29(3). See, for similar provisions, UCITS Implementing Directive (n 220), Art 28(3) and MiFID Implementing Directive (n 237), Art 49(1).

²⁵⁷ Implementing Regulation, Art 29(4), first paragraph. See, for similar provisions, UCITS Implementing Directive (n 220), Art 30(2) and MiFID Implementing Directive (n 237), Art 48(2).

²⁵⁸ Implementing Regulation, Art 29(4), second paragraph. See, for similar provisions, UCITS Implementing Directive (n 220), Art 28(4), first paragraph, and MiFID Implementing Directive (n 237), Art 49(2), first paragraph.

²⁵⁹ The essential information must at least include the following information: (i) the identification of the AIFM; (ii) the identification of the investor; (iii) the date and time of receipt of the order; (iv) the date of execution; (v) the identification of the AIF; (vi) the gross value of the order including charges for subscription or the net amount after charges for redemptions (Implementing Regulation, Art 26(3)). See, for a similar provision, UCITS Implementing Directive (n 220), Art 24(2).

²⁶⁰ Implementing Regulation, Art 26(1). See, for a more or less similar provision, UCITS Implementing Directive (n 220), Art 24(1), first paragraph, read in conjunction with Art 24(3). This obligation does not apply where a third person is obliged to provide the investor with a confirmation concerning the execution of the order and where the confirmation contains the essential information. However, AIFMs must ensure that the third person complies with its obligations (Implementing Regulation, Art 26(2)). See, for a similar provision, UCITS Implementing Directive (n 220), Art 24(1), second paragraph, but without a duty that the UCITS management company must ensure that the other person complies with its obligations.

²⁶¹ Implementing Regulation, Art 26(4). See, for a similar provision, UCITS Implementing Directive (n 220), Art 24(4).

J. Selection of counterparties and prime brokers

When selecting and appointing counterparties and prime brokers²⁶² AIFMs must exercise due skill, care, and diligence before entering into an agreement and on an ongoing basis by considering the full range and quality of their services.²⁶³ **1.245**

AIFMs must select prime brokers or counterparties of an AIFM or AIF in an OTC derivatives transaction, securities lending, or repurchase agreement which (i) are subject to ongoing supervision by a public authority,²⁶⁴ (ii) are financially sound,²⁶⁵ and (iii) have the necessary organizational structure and resources for performing the services which are to be provided by them to the AIFM or AIF.²⁶⁶ To determine whether a prime broker is ‘financially sound’, the AIFM must consider whether or not the counterparty or prime broker is subject to prudential regulation, including sufficient capital requirements and effective supervision.²⁶⁷ This requirement restricts the universe of eligible counterparties considerably. **1.246**

The list of selected prime brokers must be approved by the AIFM’s senior management. AIFMs must appoint prime brokers from the list. However, in exceptional cases prime brokers not included in the list can be appointed provided that they meet the requirements set out in paragraph 1.246 and subject to subsequent approval by senior management. **1.247**

The AIFM must be able to demonstrate the reasons for selection and the due diligence it exercised in selecting and monitoring prime brokers.²⁶⁸ The strict requirements with respect to prime brokers may be explained by the fact that during the credit crisis many AIFs suffered loss due to the insolvency of prime broker Lehman Brothers in September 2008. **1.248**

K. Individual portfolio management

If an AIFM is authorized to provide MiFID (as individual rather than collective) portfolio management, the AIFM must not invest all or part of any client’s portfolio in units or shares of its AIFs unless it receives prior general approval from the client. **1.249**

The AIFM’s MiFID services will be subject to Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes²⁶⁹ with regard to the MiFID services of (i) individual portfolio management, (ii) investment advice, (iii) safe-keeping in relation to shares or units in collective investment undertakings, and (iv) reception and transmission of orders in relation to financial instruments.²⁷⁰ **1.250**

²⁶² ‘Prime broker’ means a credit institution, regulated investment firm, or other entity subject to prudential regulation and ongoing supervision, offering services to professional investors primarily to finance or execute transactions in financial instruments as counterparty and which may also provide other services such as clearing and settlement of trades, custodial services, securities lending, customized technology, and operational support facilities (AIFMD, Art 4(1)(af)). See further on prime brokers: M. Berman (ed.), *Hedge Funds and Prime Brokers* (Risk Books, 2009); D.A. Zetzsche, ‘(Prime) Brokerage’, in Zetzsche, *The Alternative Investment Fund Managers Directive* (Kluwer Law International, 2012) (n 21) 489 et seq.

²⁶³ Implementing Regulation, Art 20(1).

²⁶⁴ Implementing Regulation, Art 20(2), opening words, and subparagraph (a).

²⁶⁵ Implementing Regulation, Art 20(2)(b).

²⁶⁶ Implementing Regulation, Art 20(2)(c).

²⁶⁷ Implementing Regulation, Art 20(3).

²⁶⁸ Implementing Regulation, Art 20(4).

²⁶⁹ OJ 1997 L84/22.

²⁷⁰ AIFMD, Art 12(2).

3. Remuneration (Article 13)

A. *O tempora, o mores*

1.251 Populist belief appears to hold that ‘the bankers’ created the financial crisis through greed and indifference. While greed and indifference, as common human traits, are certainly featuring in the financial services industry, to suggest that this is the root cause of the financial crisis is to ignore that, in essence, it concerned a fairly standard credit *cum* asset speculative bubble, be it a sizeable one, that benefited all lenders and borrowers until the bubble burst. ‘The bankers’ were a component part of the speculation that created the bubble, not the root cause of it. Market euphoria, temporary madness of a crowd of investors, causes speculative excess.

1.252 JK Galbraith may be quoted instructively:

The more obvious features of the speculative episode are manifestly clear to anyone open to understanding. Some artefact or some development, seemingly new and desirable—tulips in Holland, gold in Louisiana, real estate in Florida, the superb economic designs of Ronald Reagan—captures the financial mind or perhaps, more accurately, what so passes. The price of the object of speculation goes up. . . . The speculation building on itself provides its own momentum.²⁷¹

The operative notion is that the crowd converts the individual ‘from reasonably good sense to stupidity’, against which the ‘very Gods Themselves confound in vain’.²⁷² The artefact or development that fuelled the speculative excess that ended in 2008 was the belief that market risk, in particular credit risk, could be measured with some precision.

1.253 After the stupidity has been and gone, a cause must be identified. However, ‘those who are involved never wish to attribute stupidity to themselves. . . . The least important questions are the one most emphasized: What triggered the crash? Were there some special factors that made it so dramatic or drastic? Who should be punished?’.²⁷³ This is typically followed by the question: What, if anything, should be done? Given the ample precedent of recurring financial euphoria, Galbraith must be right when he observes that:

beyond a better perception of the speculative tendency and the process itself, there probably is not a great deal that can be done. Regulation outlawing financial incredulity or mass euphoria is not a practical possibility. If applied generally to such human condition, the result would be an impressive, perhaps oppressive, and certainly ineffective body of law.

1.254 Galbraith wrote this in the early 1990s, but it is certainly an observation that applies to the aftermath of 2008. Politicians and regulators alike, guided by the recurrent adage ‘never again’, have been busily writing an ‘impressive, perhaps oppressive’ body of rules to tame the financial services industry. Whether this body of rules will prove to be ineffective is perhaps too early to tell. However, assuming that the all-too-repetitive patterns in the history of financial euphoria are a useful guidance, the answer is most likely that it will be.

²⁷¹ J.K. Galbraith, *A short history of financial Euphoria* (Penguin, 1993) 2–3. See also pp 18–19 on the perception of ‘something new and exceptional’ as the necessary ingredient for speculative euphoria to arise.

²⁷² Galbraith, *A short history of financial Euphoria* (n 271) 5, quoting Friedrich von Schiller.

²⁷³ Galbraith, *A short history of financial Euphoria* (n 271) 106–7.

The regulation of remuneration of senior management and ‘risk takers’ in the financial services industry has been a hotly debated and much politicized component part of the new rules that ‘will’ prevent speculative excess. Recital (24) of the AIFMD observes that to: **1.255**

address the potentially detrimental effect of poorly designed remuneration structures on the sound management of risk and control of risk-taking behaviour by individuals, there should be an express obligation for AIFMs to establish and maintain, for those categories of staff whose professional activities have a material impact on the risk profiles of AIFs they manage, remuneration policies and practices that are consistent with sound and effective risk management.

Given its rhetorical nature, it is difficult to contend with this proposition. Naturally, remuneration structures should not be ‘poorly designed’. As is the case in the context of the propositions made pursuant to the notion that ‘systemic risk’ must be managed, however, the Commission is not really able to put forward empirical evidence or arguments that persuasively underpin the chosen cause of action. What is or is not a poorly designed remuneration structure remains a mystery. The most that can be gleaned from the rules is that the underlying driver appears to be the desire to limit the variable component of the remuneration relative to the fixed component. Why this is better is not explained properly. **1.256**

The remuneration principles, therefore, constitute remarkable legislative action, particularly given the fact that interference with market-set remuneration, i.e. interference with the valuation mechanism for skill and talent, is not only contrary to the basic tenets on which a capitalist market model is organized but could also have unintended consequences.²⁷⁴ It must be concluded that the remuneration principles are a plain example of the typical post-euphoria action so clearly specified by Galbraith, aimed at perceived mischief, but utterly besides the point. The last bubble was created, as were all previous bubbles, because the perception of risk was converted ‘from reasonably good sense to stupidity’. Remuneration principles designed to change risk-taking based on the financial incentives are ineffective logically if the underlying perception of risk that drives the behaviour is in error. **1.257**

B. Basic principles (Article 13 and Annex II)

Pursuant to Article 13(1) of the AIFMD (remuneration), AIFMs must have remuneration policies and practices for employees that ‘have a material impact on the risk profiles of the AIFMs or of the AIFs they manage’. This includes senior management, ‘risk takers’, control functions, and any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers. The policies must be ‘consistent with and promote sound and effective risk management and . . . not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage’. **1.258**

²⁷⁴ Not surprisingly, given the intrusive nature of the remuneration principles, recital (28) states that the ‘provisions on remuneration should be without prejudice to the full exercise of fundamental rights guaranteed by the Treaties, in particular Article 153(5) TFEU, general principles of national contract and labour law, applicable legislation regarding shareholders’ rights and involvement and the general responsibilities of the administrative and supervisory bodies of the institution concerned, as well as the right, where applicable, of social partners to conclude and enforce collective agreements, in accordance with national laws and traditions’.

- 1.259** The AIFMs must set the remuneration policies and practices in accordance with a detailed list of principles set out in Annex II. The principles apply to ‘remuneration of any type paid by the AIFM, to any amount paid directly by the AIF itself, including carried interest, and to any transfer of units or shares of the AIF’ made to staff that is in scope.²⁷⁵
- 1.260** Annex II sets out three categories of principles. The first category reinforces the key tenets of Article 13 of the AIFMD, ie that the remuneration policy must be consistent with and promote ‘sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs’.²⁷⁶ The remuneration policy must be in line with the business strategy, objectives, values, and interests of the AIFM, and the AIFs or the investors of such AIFs, and include measures to avoid conflicts of interest.²⁷⁷
- 1.261** The second category addresses the governance structure. The remuneration policy must be adopted, implemented, and periodically reviewed, at least annually, by the management body of the AIFM.²⁷⁸ The compensation of staff engaged in control functions, ie compliance and risk functions, must be set independently of the performance of the business areas they control and be overseen by the remuneration committee.²⁷⁹
- 1.262** By paragraph 3 of Annex II, in principle, AIFMs must establish an independent remuneration committee. However, the provision applies only to those AIFMs that are ‘significant in terms of their size or the size of the AIFs they manage, their internal organisation and the nature, the scope and the complexity of their activities’. The remuneration committee must be organized in a way that enables it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk. The remuneration committee advises the management body about remuneration decisions and must be chaired by a non-executive member of the management.²⁸⁰
- 1.263** The third category sets principles in relation to payment structures. These address:
- (a) performance-related pay in the context of the returns of the AIF and the overall results of the AIFM (including in a multi-year framework appropriate to the life cycle of the AIFs);²⁸¹
 - (b) guaranteed variable remuneration, which must be exceptional and limited to the hiring of new staff and to the first year;²⁸²
 - (c) fixed and variable components of total remuneration, which must be ‘appropriately balanced’ and the fixed component must represent ‘a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component’;²⁸³

²⁷⁵ AIFMD, Annex II, para 2.

²⁷⁶ AIFMD, Annex II, para 1(a).

²⁷⁷ AIFMD, Annex II, para 1(b).

²⁷⁸ AIFMD, Annex II, para 1(c), (d).

²⁷⁹ AIFMD, Annex II, para 1(e), (f).

²⁸⁰ AIFMD, Annex II, para 3.

²⁸¹ AIFMD, Annex II, para 1(g), (h).

²⁸² AIFMD, Annex II, para 1(i).

²⁸³ AIFMD, Annex II, para 1(j).

- (d) payments relating to early termination of a contract, which must ‘not reward failure’;²⁸⁴
- (e) the measurement of performance used to calculate variable remuneration, mandatory minimum 50/50 cash/equity split of variable compensation, mandatory deferral of at least five years of at least 40% of variable compensation, the operation of a retention policy on variable compensation, *malus*, or claw-back arrangements;²⁸⁵
- (f) the pension policy, which must have a mandatory retirement benefit pay-out structures, etc;²⁸⁶
- (g) anti-avoidance principles, such as a prohibition on use of personal hedging strategies and remuneration- and liability-related insurance if that would ‘undermine the risk alignment effects embedded in their remuneration arrangements’, and a prohibition on the payment of variable remuneration ‘through vehicles or methods that facilitate the avoidance of the requirements’ of the AIFMD.²⁸⁷

C. Proportionality

Paragraph 1 of Annex II introduces the principle of proportionality. AIFMs must comply with the Annex II principles ‘in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities’. The ESMA Guidelines provide guidance on how this concept of proportionality is to be applied.²⁸⁸ **1.264**

D. ESMA Guidelines

Article 13(2) of the AIFMD instructs ESMA to make guidelines on sound remuneration policies which comply with Annex II. The guidelines must take into account the principles on sound remuneration policies set out in Recommendation 2009/384/EC, the size of the AIFMs and the size of AIFs they manage, their internal organization and the nature, scope, and complexity of their activities. ESMA must cooperate closely with the European Supervisory Authority (European Banking Authority) (EBA). **1.265**

ESMA has made ‘Guidelines on sound remuneration policies under the AIFMD’.²⁸⁹ The Guidelines cover, among other things, identification of staff covered by the guidelines, application of the proportionality principle, the governance structure (including remuneration of members of the management body and shareholders’ involvement, and the periodic review), the remuneration committee (set-up, composition, role, process, and reporting lines), the control functions (roles and remuneration), the general requirements on risk alignment, the general remuneration policy (including the pension policy, discretionary pension benefits, and severance pay), personal hedging, various payment structures (including specific requirements on risk alignment, policy on variable remuneration, the performance and risk measurement process, the award process, the payout process and time horizons), and certain transparency requirements requiring publication of remuneration information. **1.266**

²⁸⁴ AIFMD, Annex II, para 1(k).

²⁸⁵ AIFMD, Annex II, para 1(l)–(o).

²⁸⁶ AIFMD, Annex II, para 1(p).

²⁸⁷ AIFMD, Annex II, para 1(q), (r).

²⁸⁸ AIFMD, recital (25) states that the ‘principles governing remuneration policies should recognise that AIFMs are able to apply those policies in different ways according to their size and the size of the AIFs they manage, their internal organisation and the nature, the scope and the complexity of their activities’.

²⁸⁹ ESMA/2013/232, 3 July 2013.

E. Efficacy of the principles

- 1.267** Many of the remuneration principles are similar to the principles set out for credit institutions and investment firms in the Capital Requirements Directive. However, the activities of managers of collective investment schemes, who invest their investors' money, not proprietary money, are different in nature and purpose from the activities of banks and broker-dealers. It is probably justified to suggest that the traditional fee structures of managers of collective investment schemes already align interests. It remains to be seen how the new principles are applied in practice in view of the proportionality principle. The focus on variable versus fixed component in the context of asset management incentives seems ill-conceived. In practice, the parallel application of principles designed in the context of banking and broker-dealer activities may frustrate the effectiveness of the existing payments structures in the asset management industry.

4. Conflicts of interest (Article 14)

A. General

- 1.268** AIFMs must maintain and operate effective organizational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage, and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors.²⁹⁰

B. Types of conflicts of interests

- 1.269** AIFMs must take all reasonable steps to identify conflicts of interest that arise in the course of managing AIFs between:

- (a) the AIFM (including its managers, employees, or any person directly or indirectly linked to the AIFM by control) and the AIF managed by the AIFM or the investors in that AIFM;
- (b) the AIF or the investors in that AIF, and another AIF or the investors in that AIF;
- (c) the AIF or the investors in that AIF, and another client of the AIFM;
- (d) the AIF or the investors in that AIF, and a UCITS managed by the AIFM or the investors in that UCITS; or
- (e) two clients of the AIFM.²⁹¹

- 1.270** For the purpose of identifying the types of conflicts of interest set out in paragraph 1.269, an AIFM must take into account, in particular, whether the AIFM, a relevant person,²⁹² or a person directly or indirectly linked by way of control to the AIFM:

- (a) is likely to make a financial gain, or avoid a financial loss, at the expense of the AIF or its investors;

²⁹⁰ AIFMD, Art 14(1), second paragraph. See, for similar provisions, UCITS Directive (n 2), Art 12(1)(b) and MiFID (n 14), Art 13(3).

²⁹¹ AIFMD, Art 14(1), first paragraph (see also Art 12(1)(d), on which see para 1.212). For a similar (but less detailed) provision, see UCITS Directive (n 2), Art 12(1)(b) and MiFID (n 14), Art 18(1).

²⁹² 'Relevant person' means any of the following: (a) a director, partner, or equivalent, or manager of the AIFM; (b) an employee of the AIFM, or any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the provision of collective portfolio management services by the AIFM; (c) a natural or legal person who is directly involved in the provision of services to the AIFM under

- (b) has an interest in the outcome of a service or an activity provided to the AIF or its investors or to a client or of a transaction carried out on behalf of the AIF or a client, which is distinct from the AIF interest in that outcome;
- (c) has a financial or other incentive to favour the interest of (a) a UCITS, a client or group of clients, or another AIF over the interest of the AIF; (b) one investor over the interest of another investor or group of investors of the same AIF;
- (d) carries out the same activities for the AIF and for another AIF, a UCITS, or client; or
- (e) receives or will receive from a person other than the AIF or its investors an inducement in relation to collective portfolio management activities provided to the AIF, in the form of monies, goods, or services other than the standard commission or fee for that service.²⁹³

C. Segregation of tasks and responsibilities

AIFMs must segregate, within their own operating environment, tasks and responsibilities which may be regarded as incompatible with each other or which may potentially generate systematic conflicts of interest. AIFMs must assess whether their operating conditions may involve any other material conflicts of interest and disclose them to the investors of the AIFs.²⁹⁴ **1.271**

D. Conflicts of interests policy

The AIFM must establish, implement, and apply an effective conflicts of interests policy. That policy must be set out in writing and must be appropriate to the size and organization of the AIFM and the nature, scale, and complexity of its business.²⁹⁵ Where the AIFM is a member of a group, the policy must also take into account any circumstances of which the AIFM is or should be aware which may give rise to conflicts of interest, resulting from the structure and business activities of other members of the group.²⁹⁶ **1.272**

The conflicts of interests policy must include: **1.273**

- (a) the identification of the circumstances which constitute or may give rise to conflicts of interests entailing a material risk of damage to the interests of the AIF or its investors, with reference to the activities carried out by or on behalf of the AIFM, including activities carried out by a (sub-)delegate, external valuer, or counterparty;²⁹⁷ and

a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM (Implementing Regulation, Art 1(2)).

²⁹³ Implementing Regulation, Art 30. See, for similar provisions, UCITS Implementing Directive (n 220), Art 17(1) and MiFID Implementing Directive (n 237), Art 21. However, the important difference is that in the case of UCITS and MiFID Implementing Directives these are merely minimum criteria (UCITS Implementing Directive (n 220) Art 27(1), opening words, MiFID Implementing Directive (n 237), Art 21, opening words). Implementing Regulation, Art 30 is based on AIFMD, Art 14(4)(a), providing that the Commission must adopt, by means of delegated acts in accordance with Art 56 and subject to the conditions of Arts 57 and 58, measures specifying the types of conflicts of interest.

²⁹⁴ AIFMD, Art 14(1), last paragraph.

²⁹⁵ Implementing Regulation, Art 31(1), first paragraph. See, for similar provisions, UCITS Implementing Directive (n 220) Art 18(1), first paragraph and MiFID Implementing Directive (n 237), Art 22(1), first paragraph.

²⁹⁶ Implementing Regulation, Art 31(1), second paragraph, based on AIFMD, Art 14(4)(b). See, for similar provisions, UCITS Implementing Directive (n 220), Art 18(1), second paragraph and MiFID Implementing Directive (n 237) Art 22(1), second paragraph.

²⁹⁷ Implementing Regulation, Art 31(2)(a), based on AIFMD, Art 14(4)(b). See, for similar provisions, UCITS Implementing Directive (n 220), Art 18(2)(a) and MiFID Implementing Directive (n 237), Art 22(2)(a), but both without any reference to activities carried out by (sub-)delegates, external valuers, and counterparties.

- (b) procedures to be followed and measures to be adopted in order to prevent, manage and monitor such conflicts.²⁹⁸

E. Independence in conflicts management

- 1.274** The procedures and measures established for the prevention or management of conflicts of interests must be designed to ensure that the relevant persons²⁹⁹ engaged in different business activities involving conflicts of interests carry out these activities having a degree of independence which is appropriate to the size and activities of the AIFM and of the group to which it belongs, and to the materiality of the risk of damage to the interests of the AIF or its investors.³⁰⁰

F. Duty to inform senior management

- 1.275** If the organizational or administrative arrangements of the AIFM are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of an AIF or investors in the AIF will be prevented, the senior management or other competent internal body of the AIFM must be promptly informed in order for them to take any necessary decision or action to ensure that the AIFM acts in the best interests of the AIF or its investors.³⁰¹

²⁹⁸ Implementing Regulation, Art 32(2)(b), based on AIFMD, Art 14(4)(b). See, for similar provisions, UCITS Implementing Directive (n 220), Art 18(2)(b) and MiFID Implementing Directive (n 237), Art 22(2)(b).

²⁹⁹ 'Relevant person' means any of the following: (a) a director, partner, or equivalent, or manager of the AIFM; (b) an employee of the AIFM, or any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the provision of collective portfolio management services by the AIFM; (c) a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM (Implementing Regulation, Art 1(2)).

³⁰⁰ Implementing Regulation, Art 33(1). See, for similar provisions, UCITS Implementing Directive (n 220), Art 19(1) and MiFID Implementing Directive (n 237), Art 22(3), first paragraph. Implementing Regulation, Art 34(2) provides a list of procedures and measures to be adopted that must be included where necessary and appropriate for the AIFM to ensure the requisite degree of independence: (a) effective procedures to prevent or control the exchange of information between relevant persons engaged in collective portfolio management activities or other activities pursuant to AIFMD, Art 6(2), (4) involving a risk of conflicts of interests where the exchange of information may harm the interest of one or more AIFs or its investors; (b) the separate supervision of relevant persons whose principal functions involve carrying out collective portfolio management activities on behalf of, or providing services to, clients or investors, whose interests may conflict, or who otherwise represent different interests that may conflict, including those of the AIFM; (c) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where conflicts of interests may arise in relation to those activities; (d) measures to prevent or restrain any person from exercising inappropriate influence over the way in which a relevant person carries out collective portfolio management activities; (e) measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate collective portfolio management activities or other activities pursuant to AIFMD, Art 6(2), (4) where such involvement may impair the proper management of conflicts of interest. However, where the adoption or application of one or more of those measures and procedures does not ensure the requisite degree of independence, the AIFM must adopt such alternative or additional measures and procedures as are necessary and appropriate for those purposes (Implementing Regulation, Art 34(2), *in fine*). See, for similar provisions, UCITS Implementing Directive (n 220), Art 19(2) and MiFID Implementing Directive (n 237), Art 22(3), second paragraph. 'Relevant person' means any of the following: (a) a director, partner or equivalent, or manager of the AIFM; (b) an employee of the AIFM, or any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the provision of collective portfolio management services by the AIFM; (c) a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM (Implementing Regulation, Art 1(2)).

³⁰¹ Implementing Regulation, Art 34. See, for a similar provision, UCITS Implementing Directive (n 220), Art 20(2). However, unlike an AIFM, a UCITS management company must report these situations to investors by any appropriate durable medium and give reasons for its decision (UCITS Implementing Directive (n 220), Art 20(3)).

G. Monitoring

The AIFM must keep and regularly update a record of the types of activities undertaken by or on behalf of the AIFM in which conflicts of interests entailing a material risk of damage to the interests of one or more AIFs or its investors have arisen or, in the case of an ongoing activity, may arise. Senior management must receive, on a frequent basis and at least annually, written reports on these activities.³⁰² **1.276**

H. Disclosure

If the organizational arrangements of the AIFM that relate to identification, prevention, management, and monitoring of conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to investors' interests will be prevented, the AIFM must clearly disclose the general nature or sources of conflicts of interest to the investors before undertaking business on their behalf, and develop appropriate policies and procedures.³⁰³ **1.277**

I. Redemption

The AIFM of an open-ended AIF must identify, manage, and monitor conflicts of interests between (i) investors wishing to redeem their investments and investors wishing to maintain their investments in the AIF, and (ii) any conflicts between the AIFM's incentive to invest in illiquid assets and the AIF's redemption policy.³⁰⁴ **1.278**

J. Prime brokers

If the AIFM uses the services of a prime broker on behalf of an AIF,³⁰⁵ the terms must be set out in a written contract. In particular, any possibility of transfer and re-use of AIF assets ('rehypothecation') must be provided for in the contract and must comply with the AIF rules or instruments of incorporation. **1.279**

The contract must provide that the depositary is informed of the contract.³⁰⁶ AIFMs must exercise due skill, care, and diligence in the selection and appointment of prime brokers with **1.280**

³⁰² Implementing Regulation, Art. 35. See, for a similar provision, UCITS Implementing Directive (n 220), Art 20(1). However, unlike Implementing Regulation, Art 35(2), Art 20(1) of the UCITS Implementing Directive (n 220) does not prescribe that senior management must receive on a frequent basis, and at least annually, written reports on the relevant activities.

³⁰³ Implementing Regulation, Art 14(2). See, for a similar provision, MiFID (n 14), Art 18(2). The information to be disclosed to investors must be provided in a durable medium or by means of a website (Implementing Regulation, Art 36(1)). Where the information is provided by means of a website and is not addressed personally to the investor, the following conditions must be satisfied: (a) the investor has been notified of the address of the website and the place on the website where the information may be accessed, and has consented to the provision of the information by such means; (b) the information must be up to date; and (c) the information must be accessible continuously by means of that website for such period of time as the investor may reasonably need to inspect it (Implementing Regulation, Art 36(2)). In the case of MiFID (n 14), the disclosure can only be made on a durable medium: see MiFID Implementing Directive (n 237), Art 22(4).

³⁰⁴ Implementing Regulation, Art 32, based on AIFMD, Art 14(4)(b). Note that the redemption policy must be in accordance with AIFMD, Art 14(1); on which, see paras 1.268–1.269.

³⁰⁵ 'Prime broker' means a credit institution, a regulated investment firm, or another entity subject to prudential regulation and ongoing supervision, offering services to professional investors primarily to finance or execute transactions in financial instruments as counterparty and which may also provide other services such as clearing and settlement of trades, custodial services, securities lending, customized technology, and operational support facilities (AIFMD, Art 4(1)(af)). See, further on prime brokers: Mark Berman (ed.), *Hedge Funds and Prime Brokers* (2nd edn, Risk Books, 2009).

³⁰⁶ Implementing Regulation, Art 14(3), first paragraph.

whom a contract is to be concluded.³⁰⁷ Although these duties are no doubt useful and necessary in order to protect the AIF and its investors, it is unfortunate that it is not made clear how these duties relate to conflicts of interest.

K. Strategies for the exercise of voting rights

- 1.281** The AIFM must develop adequate and effective strategies for determining when and how any voting rights held in its AIF portfolios are to be exercised, to the exclusive benefit of the AIF and its investors.³⁰⁸ Those strategies must determine measures and procedures for: (i) monitoring relevant corporate actions; (ii) ensuring that the exercise of voting rights is in accordance with the investment objectives and policy of the relevant AIF; (iii) preventing or managing any conflicts of interest arising from the exercise of voting rights.³⁰⁹ A summary description of the strategies and details of the actions taken on the basis of those strategies must be made available to the investors on their request.³¹⁰

5. Risk management (Article 15)

A. Requirement to maintain an independent risk function

- 1.282** Among the principle objectives of the AIFMD are improving the management of systemic risks associated with AIFs' participation in the market and improving the management of operational risk of individual AIFs through an AIFM's organizational set-up.³¹¹ Accordingly, Article 15 of the AIFMD addresses the risk management framework that individual AIFMs must have in place. The Commission has made Level 2 implementing measures which are set out in Articles 38–45 of the Implementing Regulation. Article 25 of the AIFMD addresses the systemic aspects and is discussed later.
- 1.283** As part of its operations, an AIFM must create and maintain a risk function, which is functionally and hierarchically separate and independent from the AIFM's business functions, including, in particular, portfolio management. Whether or not an AIFM's set-up is compliant is a matter for the AIFM's national regulator, who must apply proportionality principles in assessing the risk functions.³¹² Notwithstanding proportionality, an AIFM must demonstrate at least that there is effective separation and that there are effective safeguards against conflicts of interest so as to ensure independent performance of risk management activities.³¹³ This requirement corresponds to the requirements imposed on UCITS management companies.³¹⁴

³⁰⁷ Implementing Regulation, Art 14(3), second paragraph.

³⁰⁸ Implementing Regulation, Art 37(1). See, for a similar provision, UCITS Implementing Directive (n 220), Art 21(1).

³⁰⁹ Implementing Regulation, Art 37(2). See, for a similar provision, UCITS Implementing Directive (n 220), Art 21(2).

³¹⁰ Implementing Regulation, Art 37(3). See, for a similar provision, UCITS Implementing Directive (n 220), Art 21(3). However, unlike AIFMs, UCITS management companies must make a summary description of the strategies available to investors even without a request.

³¹¹ See AIFMD, recitals (2), (3), (92).

³¹² AIFMD, Art 15(1) and Implementing Regulation, Art 39.

³¹³ AIFMD, Art 15(1) and Implementing Regulation, Arts 42, 43, which provide minimum independence and conflict management requirements.

³¹⁴ See UCITS Implementing Directive (n 220), Art 12.

B. Risk management

The risk function must be supported by appropriate risk management systems.³¹⁵ These systems must be designed to ‘identify, monitor and manage appropriately’ in respect of an AIF ‘all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed’.³¹⁶ The risk management policy must set out the processes that are designed to address these risk matters.³¹⁷ The risk management systems must be monitored and periodically reviewed.³¹⁸ **1.284**

In principle, therefore, it is left to the AIFM’s risk function to determine which risks are relevant to its AIF. The risks faced by an open-ended equity fund are very different from the risks faced by a closed-ended real estate fund. Notwithstanding, the AIFMD prescribes a number of core risk tasks the AIFM must perform for its AIFs. The AIFM must have a documented investment due diligence process in place, measure and manage position risks, and ensure that the risk profile of the AIF corresponds to the investment profile of the AIF as described in its offering documents.³¹⁹ **1.285**

C. Risk limits

The risk function must set a limit for, as well as measure and manage, market, credit, liquidity, counterparty, and operational risks.³²⁰ The risk limits must be aligned with the risk profile disclosed to investors under Article 23(4) of the AIFMD. An AIFM must demonstrate to its regulator that the leverage limits set by it for each AIF it manages are reasonable and that it complies with those limits at all times.³²¹ **1.286**

It is probably fair to say that these core risk tasks may be regarded as a codification of common sense basic principles for a standard of care expected of a professional, reasonable, and prudent operator of a collective investment scheme. As is true for many other organizational and conduct principles set out in the AIFMD, these are only indicative parameters. Custom and practice of day-to-day regulatory supervision and guidance will set more detailed norms. This will take time and will lead to national differences. **1.287**

D. Leverage limit

The risk function must also set a leverage limit for each AIF. The limit must include the extent to which a counterparty may re-use collateral or the guarantee the AIF could give in the context of the leveraging, taking into account, *inter alia*, the nature of the AIF, its investment strategy, and sources of leverage, systemic risks posed by interrelationships, the need to limit concentration of exposure to a single counterparty, collateralization, and the AIF’s asset-liability ratio.³²² **1.288**

³¹⁵ AIFMD, Art 15(2) and Implementing Regulation, Art 38.

³¹⁶ AIFMD, Art 15(2) and Implementing Regulation, Art 45(1).

³¹⁷ Implementing Regulation, Art 40(3)(a).

³¹⁸ Implementing Regulation, Art 41, which contains a number of common sense requirements that most operators of AIFs should already have adhered to in practice before the AIFMD came into force.

³¹⁹ AIFMD, Art 15(3).

³²⁰ Implementing Regulation, Art 44. These matters must be addressed in the risk management policy: Implementing Regulation, Art 40(2).

³²¹ AIFMD, Art 25(3).

³²² AIFMD, Art 15(4). This must be set out in the risk management policy: Implementing Regulation, Art 40(3)(d).

- 1.289** Therefore, although the AIFMD, unlike the UCITS Directive, in principle does not aim to create a harmonized framework for the AIF's investment and borrowing powers, the imposition of risk management requirements has established common parameters around AIFs' use of leverage techniques. The limits are, nevertheless, very specific to the purpose and situation of each individual AIF. It will be for the national regulators to give guidance and create benchmarks.

6. Liquidity management (Article 16)

A. Ability to meet payment obligations

- 1.290** Article 16 of the AIFMD deals with liquidity requirements. In this context, liquidity denotes the ability of the AIF to meet its payment obligations. An AIF's payment obligations originate either from investor redemption requests or from transactions with counterparties. Naturally, therefore, closed-ended unleveraged AIFs are exempted from the requirements of Article 16. They control their redemption payments and do not have (contingent) liabilities to counterparties at the level of the AIF.
- 1.291** The ability of the AIF to meet payment obligations out of its assets depends on the rate at which obligations arise and the corresponding liquidity profile of the AIF's assets, ie the speed with which they may be sold. AIFMD, Art 16 and Articles 46–9 of the Implementing Regulation set out the framework requirements. For all AIFs other than unleveraged closed-ended AIFs, the AIFM must employ an appropriate liquidity management and monitoring system so as to ensure that the liquidity profile of the investments of the AIF meets the expected rate of redemption and other payments.³²³ The AIFM must conduct regular stress tests to ensure that the liquidity profile and the implied assumptions remain accurate.³²⁴ The AIFM must demonstrate to its national regulator that the requirements of Article 16 have been met.³²⁵

B. Alignment of investment strategy, redemption policy, and liquidity profile

- 1.292** Article 16(2) of the AIFMD provides that the AIFM must ensure that the investment strategy, the liquidity profile, and the redemption policy are consistent.³²⁶ Note that the rules are not seeking to be specific about the level of liquidity an AIFM must maintain. The AIFMD directs the AIFM to ensure that the various operative components line up properly and that reasonable and justifiable investor expectations, as set out in the offering documentation and other disclosures made by the AIFM about the AIF, are met.
- 1.293** Normally, the AIF's offering documents will have provisions to address liquidity problems. These provisions typically divide into 'gating provisions', which means that the AIFM may reduce redemptions to, for example, not more than 10% of the net asset value (NAV) on a single dealing day, and 'market distress' provisions, which permit the AIFM to close the AIF to redemptions altogether in the event that the markets in which the AIF's assets are

³²³ Implementing Regulation, Art 47 (monitoring and managing liquidity risk) sets standards for the liquidity management system and procedures. Importantly, Art 47(1)(c) requires an AIFM that invests in another fund to monitor the liquidity policies of the other fund's manager.

³²⁴ AIFMD, Art 16(1). Article 48 (liquidity management limits and stress tests) sets standards for the stress tests.

³²⁵ Implementing Regulation, Art 46.

³²⁶ AIFMD, Art 16(2).

traded are distressed such that no reliable price can be obtained or are insufficiently liquid. Separately, the offering documentation may allow for side-pockets, ie mechanisms whereby certain illiquid assets are segregated from the main portfolio of the fund for separate and independent liquidation on behalf of the investors.

Article 49(1) of the Implementing Regulation provides that, for purposes of AIFMD, Article 16(2), the ‘investment strategy, liquidity profile and redemption policy of each AIF managed by an AIFM shall be considered to be aligned when investors have the ability to redeem their investments in a manner consistent with the fair treatment of all AIF investors and in accordance with the AIF’s redemption policy and its obligations’. The fairness considerations should include the price impact on redemption.³²⁷ **1.294**

Article 49(1) therefore supports the continued use of customary redemption policies, including side-pockets. AIFMs should ensure that the terms of the redemption policies are fair in view of the interplay between investment strategy and the liquidity profile of the AIF and in line with investors’ reasonable and justifiable expectations.³²⁸ **1.295**

7. Investment in securitization positions (Article 17)

A. Securitizations and securitization special purpose entities (SSPEs)

Debt securities are issued by a variety of institutions, such as governments and governmental agencies, supranational bodies, financial institutions, and companies, and normally rank *pari passu* so that they are repayable from the issuer’s general income and assets. **1.296**

Debt securities may also be issued by separate and independent asset-backed schemes that are arranged by an interested party, normally referred to as the originator. The debt is issued by a securitization special purpose entity (SSPE). The payment of interest and the repayment of the par value upon maturity are funded by, calculated by reference to, or contingent upon, the return of an underlying portfolio of assets acquired by the SSPE, typically from the originator, with the proceeds of the issue, and typically held by the issuer in respect of that issue. Asset-backed schemes are referred to as ‘securitizations’, which is a reference to the fact that the portfolio of assets passes from the originator to the SSPE, causing the economic risk of the portfolio to be passed to the holders of the debt securities, effectively ‘securitizing’ the portfolio. **1.297**

The SSPE will issue the debt securities in ‘tranches’ that are subordinated top-down, breaking creditor *pari passu*, at least between tranches. The highest tranche is called the ‘senior’ tranche. The holders of notes in other tranches are subordinated to the holders of the senior tranche. This reduces the senior note holders’ credit risk, which means that the note will carry a lower interest rate than the subordinated tranches. The holders of the lowest tranche will only receive payment after the more senior note holders have been paid. **1.298**

Thus, the defining features of a securitization are the segregation of a portfolio of assets in the hands of an SSPE through the purchase of that portfolio by the SSPE with the proceeds of the issue of SSPE debt, the servicing of the SSPE debt by the income and capital from that portfolio, and the tranching of the SSPE into senior and junior creditor ranks. The **1.299**

³²⁷ Implementing Regulation, Art 49(2).

³²⁸ Implementing Regulation, Art 47(1)(e).

activities of the SSPE must (as it says on the tin) be restricted to securitization services without cross-contamination, ie note holders must only have recourse to the assets comprised in the reference portfolio and only in accordance with their tranche rank.

1.300 These features are recognized by Article 4(1) of the Banking Directive, which defines 'securitization' as:

a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.³²⁹

An SSPE is defined as an entity other than a bank, which is:

organised for carrying on a securitisation or securitisations, the activities of which are limited to those appropriate to accomplishing that objective, the structure of which is intended to isolate the obligations of the SSPE from those of the originator [bank], and the holders of the beneficial interests in which have the right to pledge or exchange those interests without restriction.

1.301 A similar definition can be found in Article 1(2) of the European Central Bank's Securitisation Regulation (ECB Regulation),³³⁰ which is relevant because Article 4(1)(a) of the AIFMD incorporates that definition into the Directive. The ECB Regulation defines 'securitization' as a:

'transaction or scheme whereby an asset or pool of assets is transferred to an entity that is separate from the originator and is created for or serves the purpose of the securitisation and/or the credit risk of an asset or pool of assets, or part thereof, is transferred to the investors in the securities, securitisation fund units, other debt instruments and/or financial derivatives issued by an entity that is separate from the originator and is created for or serves the purpose of the securitisation, and:

- (a) in case of transfer of credit risk, the transfer is achieved by: the economic transfer of the assets being securitised to an entity separate from the originator created for or serving the purpose of the securitisation. This is accomplished by the transfer of ownership of the securitised assets from the originator or through sub-participation, or the use of credit derivatives, guarantees or any similar mechanism; and
- (b) where such securities, securitisation fund units, debt instruments and/or financial derivatives are issued, they do not represent the originator's payment obligations.

Although more elaborate, this definition is, thankfully, not materially different from the definition in Article 4(1) of the Banking Directive.

1.302 A variety of securitizations have been created and sold in the market place over the years. The variety derives from the mix of asset classes held by the SSPE, the use of derivatives, the

³²⁹ Banking Directive, Art 4(1)(36). Article 4(1) (39) defines 'tranche' as a 'contractually established segment of the credit risk associated with an exposure or number of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in each other such segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments'.

³³⁰ Regulation (EC) No 24/2009 of the European Central Bank of 19 December 2008 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions (ECB/2008/30).

manner in which the securitized portfolio is funded or covered, and the manner in which the obligations of the issuer under the debt securities are secured.³³¹

The definitions in the Banking Directive recognize the distinctions. Article 4(1)(37) defines a ‘traditional securitisation’ as a: **1.303**

securitisation involving the economic transfer of the exposures being securitised to a securitisation special purpose entity which issues securities. This shall be accomplished by the transfer of ownership of the securitised exposures from the originator credit institution or through sub-participation. The securities issued do not represent payment obligations of the originator credit institution.

Further, Article 4(1) (38) defines a ‘synthetic securitisation’ as a ‘securitisation where the tranching is achieved by the use of credit derivatives or guarantees, and the pool of exposures is not removed from the balance sheet of the originator credit institution’.³³²

B. Investment by an AIF in securities issued by an SSPE

As discussed in paragraph 1.63, given the definition of ‘AIF’, a securitization arrangement would usually fall within the scope of the AIFMD and the SSPE would need to seek authorization as an AIFM but for the exclusion in Article (2)(3)(g). **1.304**

This does not mean, however, that SSPEs fully escape the AIFMD. Article 17 instructs the Commission, ‘in order to ensure cross-sectoral consistency and to remove misalignment between the interest of... originators... and AIFMs that invest in those securities or other financial instruments on behalf of AIFs’, to adopt delegated acts providing conditions that need to be fulfilled by ‘the originator, the sponsor or the original lender’ before it is permitted for an AIFM to invest the AIF in the securitization, which includes a condition that the originator, the sponsor, or the original lender retains a net economic interest of not less than 5%. In addition, the Commission must make a delegated act providing the ‘qualitative requirements’ an AIFM must meet to be permitted to invest the AIF in securitization positions. **1.305**

The Commission has adopted the delegated acts through Articles 50–56 of the Implementing Regulation, which incorporate the definitions of ‘securitisation’, ‘securitisation position’, ‘sponsor’, and ‘tranche’ used in Article 4 of the Banking Directive.³³³ Further, Article 56 of **1.306**

³³¹ See Lodewijk Van Setten, *The Law of Institutional Investment Management* (Oxford University Press, 2009) paras 4.70–4.75. In a basic programme, the receivables held by the SSPE and the payments due under the notes issued against those assets match, so that the funding of the payments due under the issued debt securities is covered. These securities are called ‘collateralized loan obligations’ (CLOs), ‘collateralized mortgage obligations’ (CMOs), or ‘collateralized bond obligations’ or (CBOs), in each case depending on the type of asset that is securitized through the programme. If the scheme securitizes liquid assets, such as tradable corporate loans in a CLO, the scheme may include the appointment of an investment manager who is charged with managing the securitized portfolio of loans in accordance with an investment objective.

³³² The reference to tranching being achieved through the derivatives is not necessarily accurate. The tranching is achieved through the terms of the note programme, as these apply between the SSPE and the note holders. The definition is correct to note that the ‘synthetic’ aspect is the fact that the reference portfolio is not actually transferred to the SSPE, but remains with the originator. Rather, economic exposure is transferred through swap transactions between the originator and the SSPE.

³³³ Implementing Regulation, Art 50. The definition of ‘securitisation’ as used in the Banking Directive is discussed in para 1.300. Article 4(1)(40), (1)(41), and (1)(43) of the Banking Directive, respectively, define: ‘securitisation position’ as ‘an exposure to a securitisation’; ‘originator’ as ‘either of the following: (a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or (b) an entity which purchases a third party’s exposures onto its balance sheet and

the Implementing Regulation (interpretation) provides that in the absence of interpretation by ESMA or by the Joint Committee of the ESAs, the provisions of Articles 50–56 of the Implementing Regulation, must be interpreted in a manner consistent with the corresponding provisions of the Banking Directive and the Guidelines to Article 122a of the Capital Requirements Directive, as amended.

C. Retention requirements (Articles 51 and 54 Implementing Regulation)

- 1.307** Article 51 of the Implementing Regulation requires that the originator, sponsor, or original lender retains, and explicitly discloses to the AIFM that it retains, a net economic interest of not less than 5%, which must be held in the form of notes in the tranches or by way of direct interest in the underlying exposures held by the SSPE. The ‘net economic interest’ is to be measured at origination, maintained on an ongoing basis, may not be subject to any credit risk mitigation or any short positions or any other hedge, and may not be sold.³³⁴ The retention requirement does not apply if the SSPE’s portfolio consists of ‘claims or contingent claims on or fully, unconditionally and irrevocably guaranteed by’ one or more banks.³³⁵
- 1.308** Article 54(1) of the Implementing Regulation expects the AIFM to take ‘such corrective action as is in the best interest of the investors in the relevant AIF’ if they discover that the determination and disclosure of the retained interest did not meet the requirements of the Implementing Regulation.
- 1.309** Similarly, Article 54(2) expects the AIFM to take ‘such corrective action as is in the best interest of the investors in the relevant AIF’, if the retained interest moves below the 5% threshold at a given moment, except if it is caused by the normal payment mechanism of the transaction.

D. Conditions for sponsors and originators (Implementing Regulation, Article 52)

- 1.310** Article 52 of the Implementing Regulation deals with the qualitative requirements concerning sponsors and originators. Prior to investment in a securitization the AIFM must verify the sponsor’s and originator’s organizational set-up and ‘ensure’ that the sponsor and the originator:
- grant credit based on sound and well-defined criteria and clearly establish the process for approving, amending, renewing, and refinancing loans to exposures to be securitized as they apply to exposures they hold;
 - have in place and operate effective systems to manage the ongoing administration and monitoring of their credit risk-bearing portfolios and exposures, including for identifying and managing problem loans and for making adequate value adjustments and provisions;
 - adequately diversify each credit portfolio based on the target market and overall credit strategy;
 - have a written policy on credit risk that includes their risk tolerance limits and provisioning policy and describes how it measures, monitors, and controls that risk;
 - grant readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows, and collateral supporting

then securitises them’; and ‘sponsor’ as a ‘credit institution other than an originator credit institution that establishes and manages an asset backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities’.

³³⁴ Implementing Regulation, Art 51(1).

³³⁵ Institutions listed in the first subparagraph of Art 122a(3) of the Banking Directive: see Implementing Regulation, Art 51(2).

a securitization exposure and such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures. For that purpose, materially relevant data shall be determined as at the date of the securitization and, where appropriate, due to the nature of the securitization thereafter;

- (f) grant readily available access to all other relevant data necessary for the AIFM to comply with the requirements laid down in Article 53;
- (g) disclose the level of their retained net economic interest as referred to in Article 51, as well as any matters that could undermine the maintenance of the minimum required net economic interest as referred to in that Article.

In view of the use of the words ‘shall ensure’, Article 52 places a material compliance obligation on the AIFM in respect of the securitization, which makes the AIFM effectively responsible for many operative aspects of the securitization that are outside the control of the AIFM. In practice, therefore, AIFMs will require substantial comfort letters from the originators and sponsors before making investments in securitizations. Article 1(3)(g) of the AIFMD may exclude securitizations per se from the scope of the Directive, but in many respects, Article 17 of the AIFMD and the Implementing Regulation’s implementing rules extend the Directive’s reach to securitizations in a different manner.

1.311

E. Conditions for AIFM (Implementing Regulation, Article 53)

Article 53(1) of the Implementing Regulation specifies the qualitative requirements that AIFMs must meet before they can invest an AIF’s assets in securitization positions. The AIFM must be able to demonstrate to its national regulator, in respect of each securitization position that the AIFM has ‘a comprehensive and thorough understanding of those positions’ and has implemented formal policies and procedures appropriate to the risk profile of the relevant AIF’s investment in the securitised positions, and which concern the analysis and recording of:

1.312

- (a) information about retention of economic interest by originators or sponsors;
- (b) the risk characteristics of the individual securitization position and the underlying exposures of the SSPE;
- (c) the reputation and previous securitization losses of the originators or sponsors in the relevant exposure classes;
- (d) the statements and disclosures made by the originators or sponsors, or their agents or advisors, about their due diligence on the securitized exposures and, where applicable, on the quality of the collateral supporting the securitized exposures;
- (e) where applicable, the methodologies and concepts on which the valuation of collateral supporting the securitized exposures is based and the policies adopted by the originator or sponsor to ensure the independence of the valuer;
- (f) all the structural features of the securitization that could have a material impact on the return of the securitization position, such as the contractual waterfall and waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default.

Per Article 53(2) of the AIFMD, the AIFM must make the management of the securitization position part of its risk management efforts established in accordance with Article 15 of the Directive and regularly perform stress tests appropriate to the securitization positions in accordance with Article 15(3)(b). The stress test must be ‘commensurate with the

1.313

nature, scale and complexity of the risk inherent in the securitisation positions'. In addition, the AIFM must monitor the underlying exposures of the securitization positions.³³⁶ If the underlying exposures are themselves securitization positions, AIFMs must also look through and monitor the next layer of underlying exposures.

- 1.314** Article 53(3) of the Implementing Regulation is specific about correlation risks. It expects the AIFM, for the purpose of appropriate risk and liquidity management, to identify, measure, monitor, manage, control, and report the risks that arise because of mismatches between the assets and liabilities of the AIF, concentration risk, or investment risk arising from these instruments. The AIFM must ensure that the risk profile of the securitization positions corresponds to the size, overall portfolio structure, investment strategies, and objectives of the AIF as laid down in the AIF rules or instruments of incorporation, prospectus, and offering documents.
- 1.315** Article 53(4) references the general organizational requirements of Article 18 of the AIFMD and stresses that there must be 'an adequate degree of internal reporting to the senior management so that senior management is fully aware of any material assumption of exposure to securitisations and that the risks arising from those exposures are adequately managed'. Equally, Article 53(5) insists that AIFMs treat information about securitization positions as relevant in the context of the AIFM's transparency obligations under Articles 22–24 of the AIFMD. Arguably, the reporting and transparency requirements relating to securitization positions addressed in Article 53(4) and (5) of the Implementing Regulation would apply under Articles 18 and 22–24 of the Directive without the *obiter dictum*, but it clarifies how important the Commission deems the risk management, monitoring, and reporting of securitization positions of an AIF to be.

8. General organizational requirements (Article 18)

- 1.316** Article 18 of the AIFMD imposes general organizational requirements on the AIFM, much in line with MiFID and UCITS Directive. Accordingly, an AIFM must have 'adequate and appropriate human and technical resources' necessary for the 'proper management' of AIFs. These include, without prejudice to the proportionality principle, sound administrative and accounting procedures,³³⁷ control and safeguard arrangements for electronic data processing,³³⁸ and adequate internal control mechanisms including,³³⁹ in particular, rules for personal transactions by its employees,³⁴⁰ as well as proper portfolio record-keeping systems.³⁴¹ The AIFM is also responsible for the transfer agency records.³⁴²

³³⁶ The monitoring must include, to the extent relevant, the exposure type, the percentage of loans more than 30, 60, and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, and frequency distribution of loan to value ratios with bandwidths that facilitate adequate sensitivity analysis: see Implementing Regulation, Art 53(2), second paragraph.

³³⁷ Implementing Regulation, Art 59.

³³⁸ Implementing Regulation, Art 58.

³³⁹ Implementing Regulation, Art 57.

³⁴⁰ Implementing Regulation, Art 63.

³⁴¹ Implementing Regulation, Arts 64, 66.

³⁴² Implementing Regulation, Arts 65, 66.

Naturally, the AIFM must maintain a sound governance structure and apportion responsibility for all significant business processes and functions properly to the senior management of the AIFM.³⁴³ It must also establish independent compliance and audit functions.³⁴⁴ **1.317**

9. Valuation (Article 19)

A. The net asset value (NAV) of a fund

The accurate valuation of the assets and liabilities and the calculation of the net asset value (NAV) of an open-ended AIF is absolutely critical to the proper functioning of the AIF. **1.318**

The price of a share or unit in the AIF on any dealing day is used to determine the contribution or redemption amount due to or from the fund. The unit or share price is calculated by dividing the NAV on that dealing day by the number of outstanding units or shares. If the price is not accurate, contributing investors will pay either too little for their participation, to the detriment of the existing investors, or too much, to the detriment of the contributing investor. The position is reversed if the investor is redeeming. **1.319**

The NAV is used to calculate the fees due to the AIFM and other service providers periodically. The NAV is also used to calculate the investment performance of the AIF periodically and underpins its track record. **1.320**

The matter is much less important for closed-ended AIFs as contributions ('draw-downs') and redemptions are driven by the actual cost of a purchased asset or proceeds of a sale of an asset.³⁴⁵ Fees are calculated based on the original commitment of each investor, ie a fixed number. Investors may, however, from time to time need an estimate of the value of their investment in the closed-ended AIF. **1.321**

B. Rules for determining the value of the assets and liabilities of a fund

The EU Member States do not impose specific rules for the valuation of assets and liabilities or the calculation of the net asset value of collective investment funds, including UCITS funds. Typically, the valuation is driven by a combination of rules contained in the fund's constitutive documents, the generally accepted accounting principles (GAAPs) used for that type of entity in the jurisdiction in which the fund is organized, and market practice. This makes sense as the manner of valuation is a function of the type of assets and liabilities a fund has and the variety is therefore infinite. **1.322**

Accordingly, the AIFMD requires that an AIFM has 'consistent procedures' for each AIF that permit the accurate and 'independent valuation' of the assets and liabilities of the AIF, and the calculation of its NAV pursuant to: the rules laid down in Article 19, the law of the AIF's jurisdiction of organization, and the AIF's rules or instruments of incorporation.³⁴⁶ The valuation procedures and the NAV must be disclosed to investors periodically. The valuation **1.323**

³⁴³ Art 60.

³⁴⁴ Implementing Regulation, Arts 61, 62.

³⁴⁵ See para 1.104.

³⁴⁶ AIFMD, Art 19(1), (2). Implementing Regulation, Arts 67–74 set out technical standards to which the valuation procedures must adhere, including regarding the use of models, consistency of application, periodic reviews, and frequency of valuation.

and NAV calculation must occur at least once a year and on each dealing day, if the AIF is open-ended, or each draw-down or return of capital, if the AIF is closed-ended.³⁴⁷

C. Person responsible for the valuation

- 1.324** The AIFM may perform the valuation itself or appoint an external valuer. Independency of the valuation is naturally important. Therefore, the external valuer must be an independent third party that does not have close links with the AIFM.
- 1.325** The AIF's depositary may not be the external valuer, unless it can demonstrate that its valuation function is functionally and hierarchically separate from its depositary functions. Potential conflicts of interest must be properly identified, managed, monitored, and disclosed to the investors of the AIF.
- 1.326** Equally, the AIFM may only perform the valuation function itself if it can demonstrate that the task is performed by a separate function that is independent, in particular from the portfolio management function. Independency must be safeguarded by the manner in which the function is remunerated and by other measures that mitigate conflicts of interest and prevent undue influence.³⁴⁸
- 1.327** The AIFM may not appoint an external valuer unless it can demonstrate that the external valuer is a licensed practitioner and legally subject to professional conduct rules. The external valuer must provide 'sufficient professional guarantees' certifying that it is able to perform the valuation function as required. The AIFM and the external valuer must comply with the outsourcing rules set out in Article 20 of the AIFMD and Articles 76–81 of the Implementing Regulation.³⁴⁹ Sub-delegation is not permitted.³⁵⁰ Note that a data vendor is not an external valuer for purposes of Article 19 of the Directive.
- 1.328** The AIFM must inform its national regulator of the appointment of an external valuer, who may reject the appointment if it deems it not in compliance with the requirement outlined in the previous paragraph.³⁵¹ If the AIFM values internally, its national regulator may require verification of the valuation procedures and/or valuations by an external valuer or auditor.³⁵²

D. Liability for valuation

- 1.329** Article 19(10) of the AIFMD appears to create or preserve private rights of actions for an AIF and its investors in connection with losses arising from valuation errors and other failures of the AIFM or a professional valuer to whom the AIFM has delegated valuation functions, to perform the valuation responsibilities.
- 1.330** The AIFMD's liability provisions raise general questions about their legal nature and operation.³⁵³
- 1.331** The most common source for losses in open-ended funds are NAV errors, which cause the units or shares to be over- or underpriced. That causes losses for the contributing or

³⁴⁷ AIFMD, Art 19(3).

³⁴⁸ AIFMD, Art 19(4).

³⁴⁹ AIFMD, Art 19(5).

³⁵⁰ AIFMD, Art 19(6).

³⁵¹ AIFMD, Art 19(7).

³⁵² AIFMD, Art 19(9).

³⁵³ See paras 1.13–1.22.

redeeming investor, or the existing or remaining investors in the fund, depending on the direction of travel. The fund's operator will usually make the fund whole if there is an over-priced redemption or an underpriced contribution, and reimburse the investor if it is the other way around.

V. Delegation of AIFM Functions

1. General

In practice, a fund management company tends to delegate the performance of the investment management, administrative, and marketing functions to other, specialist, financial services providers. The custodian of the fund, normally a credit institution, is typically also appointed to perform valuation and often transfer agency functions. Consequently, although the delegation may not detract from the fund management company's liability for the performance of the collective management functions, the fund management company's de facto task will be to select, monitor, and supervise the specialist providers. **1.332**

The AIFMD recognizes that an AIFM that wishes to manage its business efficiently may delegate responsibility for the performance of its AIF management functions.³⁵⁴ Sub-delegation is also permitted, subject to the AIFMD's conditions. AIFMs, however, remain responsible for the proper performance of the delegated functions and compliance with the Directive at all times.³⁵⁵ **1.333**

The AIFMD delegation conditions only apply to the delegation of the core management functions specified in Annex I of the AIFMD, i.e. collective portfolio management and risk management. Delegation of supporting tasks, such as administrative or technical functions performed by the AIFM as a part of its management tasks, should not be subject to the specific limitations and requirements set out in the Directive.³⁵⁶ **1.334**

The AIFMD delegation regime is based on a mixture of the MiFID and UCITS delegation rules, but the AIFMD requires 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 its investors.³⁵⁷ **1.335**

2. Conditions for delegation

A. General

AIFMs that intend to delegate to third parties the task of carrying out functions on their behalf must notify the competent authorities of their home Member State *before* the delegation **1.336**

³⁵⁴ FSA, DP 12/1 (n 213) 37, paras 4.42–4.43.

³⁵⁵ AIFMD, recital (30).

³⁵⁶ AIFMD, recital (31).

³⁵⁷ Cf. FSA, DP 12/1 (n 213) 37–8, para 4.45. See also, on delegation, T. Partsch and J. Mullmaier, 'Delegation', in Zetzsche, *The Alternative Investment Fund Managers Directive* (Kluwer Law International, 2012) (n 21) 217 et seq.

arrangements become effective.³⁵⁸ In addition, to be able to delegate, an extensive list of positive and negative conditions must be met. These are set out in the following sections.

B. Justification delegation

- 1.337** The AIFM must be able to justify the delegation structure with an objective rationale.³⁵⁹ Accordingly, it must provide the competent authorities with a detailed description, explanation, and evidence of the objective reasons for the delegation.
- 1.338** The following criteria must be considered when assessing whether the delegation structure is based on objective reasons: (i) optimizing of business functions and processes; (ii) cost saving; (iii) expertise of the delegate in administration or in specific markets or investments; (iv) access of the delegate to global trading capabilities.³⁶⁰ Upon request from the competent authorities the AIFM must provide further explanations and provide documents proving that the entire delegation structure is based on objective reasons.³⁶¹

C. Delegation arrangements in writing; clear allocation of rights and obligations

- 1.339** The delegation arrangements must be in the form of a written agreement concluded between the AIFM and the delegate.³⁶²
- 1.340** The respective rights and obligations of the AIFM and the delegate must be allocated clearly and specified in the agreement. In particular, the AIFM must contractually ensure its instruction and termination rights, its rights of information, and its right to inspections and access to books and premises. The agreement must make sure that sub-delegation can take place only with the consent of the AIFM.³⁶³

D. Features of the delegate

- 1.341** The delegate must have sufficient resources to perform the respective tasks, and the persons who effectively conduct the business of the delegate must be of sufficiently good repute and sufficiently experienced.³⁶⁴

³⁵⁸ AIFMD, Art 20(1), first sentence. Cf. UCITS Directive (n 2), Art 13(1)(a).

³⁵⁹ AIFMD, Art 20(1)(a).

³⁶⁰ Implementing Regulation, Art 76(1).

³⁶¹ Implementing Regulation, Art 76(2).

³⁶² Implementing Regulation, Art 75(d).

³⁶³ Implementing Regulation, Art 78(h).

³⁶⁴ AIFMD, Art 20(1)(b). See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(2) (a). In order to fulfil these requirements, the following criteria must be met: (a) a delegate must have sufficient resources and must employ sufficient personnel with the skills, knowledge, and expertise necessary for the proper discharge of the tasks delegated to it and have an appropriate organizational structure supporting the performance of the delegated tasks (Implementing Regulation, Art 77(1)); (b) persons who effectively conduct the activities delegated by the AIFM must have sufficient experience, appropriate theoretical knowledge and appropriate practical experience in the relevant functions. Their professional training and the nature of the functions they performed in the past must be appropriate for the conduct of the business (Implementing Regulation, Art 77(2)); (c) persons who effectively conduct the business of the delegate are not deemed of sufficiently good repute if they have any negative records relevant both for the assessment of good repute and for the proper performance of the delegated tasks or if there is other relevant information which affects their good reputation. Such negative records include but are not limited to criminal offences, judicial proceedings, or administrative sanctions relevant for the performance of the delegated tasks. Special attention must be given to any offences relating to financial activities, including but not limited to obligations relating to the prevention of money laundering, dishonesty, fraud or financial crime, bankruptcy, or insolvency. Other relevant information includes information such as that indicating that the person is not trustworthy or honest (Implementing Regulation, Art 77(3), first paragraph). Where the delegate is regulated in respect of its professional services

E. Portfolio and risk management

Where the delegation concerns portfolio or risk management, it must be conferred only on undertakings which are authorized or registered for the purpose of asset management and subject to supervision or, where that condition cannot be met, only subject to prior approval by the competent authorities of the AIFM's home Member State.³⁶⁵ **1.342**

Where the delegation concerns portfolio or risk management and is conferred on a third-country undertaking, in addition to the requirements set out in paragraph 1.342, cooperation between the competent authorities of the home Member State of the AIFM and the supervisory authority of the undertaking must be ensured.³⁶⁶ **1.343**

Where it concerns portfolio management, the delegation must be in accordance with the investment policy of the AIF. The delegate must be instructed by the AIFM how to implement the investment policy and the AIFM must monitor whether the delegate complies with it on an ongoing basis.³⁶⁷ **1.344**

F. Effective supervision; AIFMD conditions not undermined

The delegation must not prevent the effectiveness of supervision of the AIFM, and, in particular, must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors.³⁶⁸ In line with this, the conditions with which the AIFM must

within the Union, factors referred to in Art 77(3), first paragraph, are deemed to be satisfied when the relevant supervisory authority has reviewed the criterion of 'good repute' within the authorization procedure unless there is evidence to the contrary (Implementing Regulation, Art 77(3), second paragraph).

³⁶⁵ AIFMD, Art 29(1)(c). In a similar vein, Art 13(1)(c) of the UCITS Directive (n 2) provides that in the case of delegation of investment management, the mandate must be given only to undertakings which are authorized or registered for the purpose of asset management and subject to prudential supervision. Unlike the UCITS regime, the AIFMD regime specifies that the following entities are deemed as being authorized or registered for the purpose of asset management and subject to supervision: (a) UCITS management companies authorized under the UCITS Directive (n 2); (b) investment firms authorized under MiFID (n 14) to perform portfolio management; (c) credit institutions authorized under Directive 2006/48/EC having the authorization to perform portfolio management under MiFID (n 14); and (d) external AIFMs authorized under the AIFMD. See Implementing Regulation, Art 78(2).

³⁶⁶ AIFMD, Art 29(1)(d). Similarly UCITS Directive (n 2), Art 13(1)(d) and MiFID Implementing Directive (n 237), Art 15(1). Unlike the UCITS and MiFID regimes, the AIFMD regime specifies that the following conditions must be fulfilled: (i) a written arrangement must exist between the competent authorities of the home Member State of the AIFM and the supervisory authorities of the undertaking to which delegation is conferred; (ii) with respect to the undertaking to which delegation is conferred, the arrangement referred to in (i) allows the competent authorities to: (a) obtain on request the relevant information necessary to carry out their supervisory tasks as provided for in AIFMD; (b) obtain access to the documents relevant for the performance of their supervisory duties maintained in the third country; (c) carry out on-site inspections on the premises of the undertaking to which functions were delegated. The practical procedures for on-site inspections must be detailed in the written arrangement; (d) receive as soon as possible information from the supervisory authority in the third country for the purpose of investigating apparent breaches of the requirements of the AIFMD and its implementing measures; and (e) cooperate in enforcement in accordance with the national and international law applicable to the supervisory authority of the third country and the EU competent authorities in cases of breach of the requirements of AIFMD and its implementing measures and relevant national law. See Implementing Regulation, Art 78(3).

³⁶⁷ Implementing Regulation, Art 75(i).

³⁶⁸ AIFMD, Art 20(1)(e). See, for a similar provision, UCITS Directive (n 2), Art 13(1)(b). However, unlike the UCITS regime, the AIFMD regime specifies that a delegation prevents the effectiveness of supervision of the AIFM where: (a) the AIFM, its auditors, and the competent authorities do not have effective access to data related to the delegated functions and to the business premises of the delegate, or the competent authorities are not able to exercise those rights of access; (b) the delegate does not cooperate with the competent authorities of the AIFM in connection with the delegated functions; and (c) the AIFM does not make available on request

comply in order to be authorized and carry out activities in accordance with the AIFMD must not be undermined.³⁶⁹

G. Selection, monitoring, and review of delegates, instruction, and withdrawal

- 1.346** The AIFM must be able to demonstrate (i) that the delegate is qualified and capable of undertaking the functions in question,³⁷⁰ (ii) that it was selected with all due care and (iii) that the AIFM is in a position (a) to monitor effectively at any time the delegated activity,³⁷¹ (b) to give at any time further instructions to the delegate,³⁷² and (c) to withdraw the delegation with immediate effect when this is in the interest of investors.^{373, 374} The AIFM must review the services provided by each delegate on an ongoing basis.³⁷⁵
- 1.347** The AIFM must ensure that the delegate carries out the delegated functions effectively and in compliance with applicable law and regulatory requirements and must establish methods and procedures for reviewing, on an ongoing basis, the services provided by the delegate.³⁷⁶ The AIFM must ensure that the delegate discloses to the AIFM any development that may have a material impact on the delegate's ability to carry out the delegated functions effectively and in compliance with applicable laws and regulatory requirements.³⁷⁷ The AIFM must take appropriate action if it appears that the delegate may not be carrying out the functions effectively or not in compliance with applicable laws and regulatory requirements.³⁷⁸
- 1.348** The AIFM must supervise the delegated functions and manage the risks associated with the delegation effectively.³⁷⁹ For this purpose the AIFM must have at all times the necessary expertise and resources to supervise the delegate's functions.³⁸⁰ The AIFM must set out in the agreement its right of information, inspection, admittance, and access and its instruction and monitoring rights against the delegate. The AIFM must also ensure that the delegate properly supervises the performance of the delegated functions, and adequately manages the risks associated with the delegation.³⁸¹

to the competent authorities all information necessary to enable authorities to supervise the compliance of the performance of the delegate's functions with the requirements of the AIFMD and its implementing measures. See Implementing Regulation, Art 78.

³⁶⁹ Implementing Regulation, Art 75(c). See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(1)(c), (d).

³⁷⁰ See, for a similar provision, UCITS Directive (n 2), Art 13(1)(h).

³⁷¹ See, for a similar provision, UCITS Directive (n 2), Art 13(1)(f).

³⁷² See, for a similar provision, UCITS Directive (n 2), Art 13(1)(g).

³⁷³ See, for a similar provision, UCITS Directive (n 2), Art 13(1)(g), second part. See also MiFID Implementing Directive (n 237), Art 14(2)(g).

³⁷⁴ AIFMD, Art 20(1)(f), first paragraph. See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(2), first paragraph.

³⁷⁵ AIFMD, Art 20(1)(f), second paragraph.

³⁷⁶ Implementing Regulation, Art 75(e), first sentence. See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(2)(b).

³⁷⁷ Implementing Regulation, Art 75(j). See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(2)(f).

³⁷⁸ Implementing Regulation, Art 75(e), second sentence. See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(2)(d).

³⁷⁹ Implementing Regulation, Art 75(f), first sentence. See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(2)(c).

³⁸⁰ Implementing Regulation, Art 75(f), second sentence. See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(2)(e).

³⁸¹ Implementing Regulation, Art 75(f), third sentence onwards.

The AIFM must ensure that the continuity and quality of the delegated functions or of the delegated task of carrying out functions are also maintained in the event of a termination of the delegation either by transferring the delegated functions or the delegated task of carrying out functions to another third party or by performing them itself.³⁸² **1.349**

The AIFM must ensure that the delegate protects any confidential information relating to the AIFM, the AIF affected by the delegation, and the investors in that AIF.³⁸³ **1.350**

The AIFM must ensure that the delegate establishes, implements, and maintains a contingency plan for disaster recovery and periodic testing of backup facilities while taking into account the types of delegated functions.³⁸⁴ **1.351**

H. Conflicts of interests

a. General

Delegation of portfolio management or risk management will not be conferred on: (i) a depositary or a delegate of the depositary; or (ii) any other entity whose interests may conflict with those of the AIFM or the investors of the AIF, *unless* (a) such entity has functionally and hierarchically separated the performance of its portfolio management or risk management tasks from its other potentially conflicting tasks, and (b) the potential conflicts of interest are properly identified, managed, monitored, and disclosed to the investors of the AIF.³⁸⁵ **1.352**

b. Types of conflicts of interests

The criteria to assess whether a delegation conflicts with the interests of the AIFM or the investors of the AIF must at least include: **1.353**

- (a) where the AIFM and the delegate are members of the same group or have any other contractual relationship, the extent to which the delegate controls the AIFM or has the ability to influence its actions;
- (b) where the delegate and an investor of the AIF are members of the same group or have any other contractual relationship, the extent to which this investor controls the delegate or has the ability to influence its actions;
- (c) the likelihood that the delegate makes a financial gain, or avoids a financial loss, at the expense of the AIFM or the investors of the AIF;
- (d) the likelihood that the delegate has an interest in the outcome of a service or an activity provided to the AIFM or the AIF;
- (e) the likelihood that the delegate has a financial or other incentive to favour the interest of another client over the interests of the AIFM or the investors of the AIF;
- (f) the likelihood that the delegate receives or will receive from a person other than the AIFM an inducement in relation to the collective portfolio management activities provided to the AIFM and its AIFs in the form of monies, goods, or services other than the standard commission or fee for that service.³⁸⁶

³⁸² Implementing Regulation, Art 75(g).

³⁸³ Implementing Regulation, Art 75(k). See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(2)(j).

³⁸⁴ Implementing Regulation, Art 75(l). See, for a similar provision, MiFID Implementing Directive (n 237), Art 14(2)(k).

³⁸⁵ AIFMD, Art 20(2). Similarly, UCITS Directive (n 2), Art 13(1)(e), but without the escape provided by AIFMD, Art 20(2)(b) ('unless...'). In a similar vein, see Art 25(2), second paragraph of the European Commission's proposal for UCITS V, 3 July 2012 (COM(2012) 350 final).

³⁸⁶ See Implementing Regulation, Art 80(1). Such specification is absent in the UCITS regime.

c. Separation of functions

1.354 The portfolio or risk management function may be considered to be functionally and hierarchically separated from other potentially conflicting tasks only where the following conditions are satisfied:

- (a) persons engaged in portfolio management tasks are not engaged in the performance of potentially conflicting tasks such as controlling tasks;
- (b) persons engaged in risk management tasks are not engaged in the performance of potentially conflicting tasks such as operating tasks;
- (c) persons engaged in risk management functions are not supervised by those responsible for the performance of operating tasks;
- (d) the separation is ensured throughout the whole hierarchical structure of the delegate up to its governing body and is reviewed by the governing body and, where it exists, the supervisory function of the delegate.³⁸⁷

d. Identification, management, monitoring, and disclosure of conflicts of interests

1.355 Potential conflicts of interest are deemed properly identified, managed, monitored, and disclosed to the investors of the AIF only if:

- (a) the AIFM ensures that the delegate takes all reasonable steps to identify, manage, and monitor potential conflicts of interest that may arise between itself and the AIFM, the AIF, or the investors of the AIF. The AIFM must ensure that the delegate has procedures in place corresponding to those set out in Articles 31–34 of the Implementing Regulation;
- (b) the AIFM ensures that the delegate discloses potential conflicts of interest as well as the procedures and measures to be adopted by it in order to manage such conflicts of interest to the AIFM, which must disclose them to the investors of the AIF in accordance with Article 36 of the Implementing Regulation.³⁸⁸

3. AIFM's liability not affected by delegation

1.356 The AIFM's liability towards the AIF and its investors is not affected by the fact that the AIFM has delegated functions to a third party, or by any further sub-delegation.³⁸⁹ In line with the rule that the AIFM's liability towards the AIF and its investors is not affected by (sub-)delegation, the AIFMD framework also provides that (i) the delegation structure does not allow for the circumvention of the AIFM's responsibilities or liability³⁹⁰ and (ii) the obligations of the AIFM towards the AIF and its investors must not be altered as a result of the delegation.³⁹¹

³⁸⁷ See Implementing Regulation, Art 80(2). Such specification is absent in the UCITS regime, because under that regime the UCITS management company is simply not entitled to delegate investment management to undertakings whose interests may conflict with those of the UCITS management company or the unit-holders, even if such entity has functionally and hierarchically separated the performance of its investment management from other potentially conflicting tasks. See UCITS Directive (n 2), Art 13(1)(e).

³⁸⁸ Implementing Regulation, Art 80(3). A similar provision is absent in the UCITS regime.

³⁸⁹ AIFMD, Art 20(3), first part. For a similar provision, see UCITS Directive (n 2), Art 13(2), first sentence, but without any explicit reference to sub-delegation.

³⁹⁰ Implementing Regulation, Art 75(a).

³⁹¹ Implementing Regulation, Art 75(b). Article 14(1)(b) of the MiFID Implementing Directive (n 237) similarly provides that the relationship and obligations of the investment firm towards its clients under MiFID must not be altered.

The AIFMD's liability provisions raise general questions about their legal nature and operation.³⁹² **1.357**

4. *AIFM may not become a letter-box entity*

The AIFM may not delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF so that it has become a 'letter-box entity'.³⁹³ **1.358**

An AIFM is deemed no longer to be the manager of the AIF if at least (ie minimum harmonization; Member States may impose stricter rules) any of the following situations occur: **1.359**

- (a) the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;
- (b) the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions, in particular in relation to the implementation of the general investment policy and investment strategies;
- (c) the AIFM loses its contractual rights to inquire, inspect, have access to, or give instructions to its delegates or the exercise of such rights becomes impossible in practice;
- (d) the AIFM delegates the performance of investment management functions to an extent that exceeds the investment management functions performed by the AIFM by a substantial margin.³⁹⁴

When assessing the extent of delegation referred to at (d), competent authorities must assess the delegation structure in its entirety, taking into account not only the assets managed under delegation but also the following: **1.360**

- (a) the types of assets the AIF, or the AIFM acting on behalf of the AIF, is invested in, and the importance of the assets managed under delegation for the risk and return profile of the AIF;
- (b) the importance of the assets under delegation for the achievement of the AIF's investment goals;
- (c) the geographical and sectoral spread of the AIF's investments;
- (d) the risk profile of the AIF;
- (e) the type of investment strategies pursued by the AIF or the AIFM acting on behalf of the AIF;
- (f) the types of tasks delegated in relation to those retained; and
- (g) the configuration of delegates and their sub-delegates, their geographical sphere of operation, and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM.³⁹⁵

³⁹² See paras 1.13–1.22.

³⁹³ AIFMD, Art 20(3), second part. See, for a similar provision, UCITS Directive (n 2), Art 13(2), second sentence.

³⁹⁴ Implementing Regulation, Art 82(1)(a)–(d). A similar further specification is not provided in the UCITS regime.

³⁹⁵ Implementing Regulation, Art 82(d), second sentence onwards. A similar further specification is not provided in the UCITS regime. The Commission must monitor, in the light of market developments, the application of Implementing Regulation, Art 82. The Commission must review the situation after two years and, if necessary, take appropriate measures to further specify the conditions under which the AIFM is deemed to have delegated its functions to the extent that it becomes a letter-box entity and can no longer be considered to be manager of the AIF (Implementing Regulation, Art 82(2)). ESMA may issue guidelines to ensure a consistent assessment of delegation structures across the Union (Implementing Regulation, Art 82(3)).

5. Sub-delegation

- 1.361** The third party may sub-delegate any of the functions delegated to it provided that (i) the AIFM consented prior to the sub-delegation,³⁹⁶ (ii) the AIFM notified the competent authorities of its home Member State before the sub-delegation arrangements become effective,³⁹⁷ and (iii) the conditions set out in Article 20(1) are met (see paragraphs 1.336 to 1.355), on the understanding that all references to the ‘delegate’ are read as references to the ‘sub-delegate’.³⁹⁸ Where the sub-delegate further delegates any of the functions delegated to it, these conditions apply *mutatis mutandis*.³⁹⁹
- 1.362** Similar to the conditions for delegation, portfolio management or risk management may not be sub-delegated to the depositary or a delegate of the depositary, or any other entity whose interests may conflict with those of the AIFM or the investors of the AIF, *unless* (a) such entity has functionally and hierarchically separated the performance of its portfolio management or risk management tasks from its other potentially conflicting tasks, and (b) the potential conflicts of interest are properly identified, managed, monitored, and disclosed to the investors of the AIF.⁴⁰⁰ Also in a similar vein as with respect to delegation, the relevant delegate must review the services provided by each sub-delegate on an ongoing basis.⁴⁰¹

VI. Depositary

1. General

- 1.363** The AIFMD depositary regime has been the subject of much discussion, especially the strict liability of the depositary. The depositary regime is a direct response to the Madoff affair. This can be gleaned from recital (32) of the AIFMD, which observes that:

[r]ecent developments underline the crucial need to separate asset safekeeping and management functions, and to segregate investor assets from those of the manager. Although AIFMs manage AIFs with different business models and arrangements for, *inter alia*, asset safekeeping, it is essential that a depositary separate from the AIFM is appointed to exercise depositary functions with respect to AIFs.⁴⁰²

- 1.364** The provisions of the AIFMD relating to the appointment and the tasks of a depositary apply to all AIFs managed by an AIFM subject to the AIFMD and therefore to all AIF business models. They should, however, be adapted to the specificities of different business models. For some business models certain depositary tasks are more relevant than for

³⁹⁶ AIFMD, Art 20(4)(a). A sub-delegation becomes effective where the AIFM demonstrates its consent to it in writing. A general consent given in advance by the AIFM is not deemed consent under AIFMD, Art 20(4)(a). See AIFMD, Art 81(1).

³⁹⁷ AIFMD, Art 20(4)(b). The notification must contain (i) details of the delegate, (ii) the name of the competent authority where the sub-delegate is authorized or registered, (iii) the delegated functions, (iv) the AIFs affected by the sub-delegation, (v) a copy of the written consent by the AIFM, and (vi) the intended effective date of the sub-delegation. See Implementing Regulation, Art 81(2).

³⁹⁸ AIFMD, Art 20(4)(c).

³⁹⁹ AIFMD, Art 20(6).

⁴⁰⁰ AIFMD, Art 20(5), first paragraph.

⁴⁰¹ AIFMD, Art 20(5), second paragraph.

⁴⁰² On the Madoff point, see also ‘The Depositary’, in Zetzsche, *The Alternative Investment Fund Managers Directive* (n 21) 409 ff.

others, depending on the type of assets the AIFs are investing in and the tasks related to those assets.⁴⁰³

The depositary has three primary functions: (1) cash monitoring;⁴⁰⁴ (2) safekeeping of an AIF's assets;⁴⁰⁵ and (3) oversight of certain operational functions.⁴⁰⁶ **1.365**

2. Single depositary for each AIF

The AIFM is responsible for ensuring that each AIF has a single depositary appointed in accordance with the AIFMD regime.⁴⁰⁷ **1.366**

In some fund structures, AIFMs are not responsible for appointing the depositary, for instance an AIF in corporate form that is externally managed by the AIFM. The AIFM does not control whether a depositary is in fact appointed. Since the AIFMD does not regulate AIFs, it cannot require an AIF to appoint a depositary. In cases of failure of an AIFM to ensure compliance with the applicable requirements of an AIF or another entity on its behalf, the competent authorities should require the AIFM to take the necessary steps to remedy the situation. **1.367**

If, despite such steps, the non-compliance persists, and in so far as it concerns an EU AIFM or an authorized non-EU AIFM managing an EU AIF, the AIFM should resign as manager of that AIF. If the AIFM fails to resign, the competent authorities of its home Member State should require such resignation, and the marketing in the Union of the AIF concerned should no longer be permitted. The same prohibition should apply to authorized non-EU AIFMs marketing non-EU AIFs in the Union.⁴⁰⁸ **1.368**

3. Depositary contract

A. Parties to the contract

A contract appointing the depositary must be made between the depositary, on the one hand, and the AIFM and, as the case may be, or the AIF, on the other hand.⁴⁰⁹ **1.369**

B. Written form

The appointment of the depositary must be evidenced by a written contract.⁴¹⁰ Unless otherwise provided by national law, there is no obligation to enter into a specific written agreement for each AIF; it is possible for the AIFM and the depositary to enter into a framework agreement listing the AIFs managed by the AIFM to which the agreement applies.⁴¹¹ **1.370**

⁴⁰³ AIFMD, recital (33).

⁴⁰⁴ AIFMD, Art 21(7).

⁴⁰⁵ AIFMD, Art 21(8).

⁴⁰⁶ AIFMD, Art 21(9).

⁴⁰⁷ AIFMD, Art 21(1). In a similar vein, Art 22(1) of the European Commission's proposal for UCITS V (n 385).

⁴⁰⁸ AIFMD, recital (11).

⁴⁰⁹ Implementing Regulation, Art 83, opening words.

⁴¹⁰ AIFMD, Art 21(2), first sentence and Implementing Regulation, Art 83(3). In a similar vein Art 22(2), first sentence of the European Commission's proposal for UCITS V (n 385).

⁴¹¹ Implementing Regulation, Art 83(5). See, for a similar provision, UCITS Implementing Directive (n 220), Art 36.

The details that must at least be addressed are described in the contract appointing the depositary or in any subsequent amendment to the contract, which must also be in writing.⁴¹² These details are set out in the following sections.

C. Services to be provided

- 1.371** The agreement must contain a description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the AIF may invest and which must then be entrusted to the depositary.⁴¹³

D. Safe-keeping and oversight function

- 1.372** The agreement must contain a description of the way in which the safe-keeping and oversight function must be performed depending on the types of assets and the geographical regions in which the AIF plans to invest. With respect to the custody duties this description must include country lists and procedures for adding or, as the case may be, withdrawing countries from that list. This must be consistent with the information provided in the AIF rules, instruments of incorporation, and offering documents regarding the assets in which the AIF may invest.⁴¹⁴

E. Depositary liability in case of delegation

- 1.373** The agreement must contain a statement that the depositary's liability is not affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with the requirements of Article 21(13) or (14) of the AIFMD.⁴¹⁵

F. Period of validity, amendment, termination

- 1.374** The agreement must contain the period of validity and the conditions for amendment and termination of the contract including the situations which could lead to the termination of the contract and details regarding the termination procedure and, if applicable, the procedures by which the depositary should send all relevant information to its successor.⁴¹⁶

G. Confidentiality

- 1.375** The agreement must contain the confidentiality obligations applicable to the parties in accordance with prevailing laws and regulations. These obligations do not impair the ability of Member States' competent authorities to have access to the relevant documents and information.⁴¹⁷

H. Transmission of information

- 1.376** The contract must regulate the flow of information deemed necessary to allow the depositary to perform its functions for the AIF for which it has been appointed as depositary, as set out in the AIFMD and in other relevant laws, regulations, or administrative provisions.⁴¹⁸ The

⁴¹² Implementing Regulation, Art 83(2), (3). See, for similar provisions, UCITS Directive (n 2), Arts 23(5) and 33(5).

⁴¹³ Implementing Regulation, Art 83(1)(a).

⁴¹⁴ Implementing Regulation, Art 83(1)(b). Cf. UCITS Implementing Directive (n 220), Art 30(a).

⁴¹⁵ Implementing Regulation, Art 83(c). Cf. UCITS Implementing Directive (n 220), Art 32(c).

⁴¹⁶ Implementing Regulation, Art 83(d). Cf. UCITS Implementing Directive (n 220), Art 33.

⁴¹⁷ Implementing Regulation, Art 83(e). See, similarly, UCITS Implementing Directive (n 220), Art 31(1) (b) and (2).

⁴¹⁸ AIFMD, Art 21(2), second sentence. In a similar vein, see Art 22(2), second sentence of the European Commission's proposal for UCITS V (n 385).

parties may agree to transmit part or all of the information that flows between them electronically provided that proper recording of such information is ensured.⁴¹⁹

The agreement must contain the means and procedures by which the depositary transmits to the AIFM or the AIF all relevant information that it needs to perform its duties including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate picture of the AIF's accounts.⁴²⁰ **1.377**

The agreement must also contain the means and procedures by which the AIFM or the AIF transmits all relevant information or ensures that the depositary has access to all the information it needs to fulfil its duties, including the procedures ensuring that the depositary will receive information from other parties appointed by the AIF or the AIFM.⁴²¹ **1.378**

I. Re-use of assets/rehypothecation

The agreement must contain information on whether or not the depositary, or a third party to whom safe-keeping functions are delegated in accordance with Article 21(11) of the AIFMD, may re-use the assets it has been entrusted with and, if any, the conditions attached to any such re-use ('rehypothecation').⁴²² **1.379**

J. Amendment of AIF rules, instruments of incorporation, offering documents

The agreement must contain the procedures to be followed when an amendment to the AIF rules, instruments of incorporation, or offering documents is being considered, detailing the situations in which the depositary is to be informed, or where the prior agreement of the depositary is needed to proceed with the amendment.⁴²³ **1.380**

K. Sale, subscription, redemption, issue, cancellation, and repurchase

The agreement must contain all necessary information that needs to be exchanged between the AIF, the AIFM, or a third party acting on behalf of the AIF or the AIFM, on the one hand, and the depositary, on the other hand, related to the sale, subscription, redemption, issue, cancellation, and re-purchase of units or shares of the AIF.⁴²⁴ **1.381**

L. Oversight and control

The agreement must contain all necessary information to be exchanged between the AIF, the AIFM, a third party acting on behalf of the AIF or the AIFM, and the depositary relating to the carrying-out of the depositary's oversight and control function.⁴²⁵ **1.382**

M. Third parties

Where the parties to the contract envisage appointing third parties to carry out parts of their respective duties, the agreement must contain a commitment to provide, on a regular basis, details of any third party appointed and, upon request, information on the criteria used to **1.383**

⁴¹⁹ Implementing Regulation, Art 83(4). See, for a similar provision, UCITS Implementing Directive (n 220), Art 35.

⁴²⁰ Implementing Regulation, Art 83(f). See, for a similar provision, UCITS Implementing Directive (n 220), Art 30(c).

⁴²¹ Implementing Regulation, Art 83(g). Cf. UCITS Implementing Directive (n 220), Art 30(d).

⁴²² Implementing Regulation, Art 83(h).

⁴²³ Implementing Regulation, Art 83(i). See, for a similar provision, UCITS Implementing Directive (n 220), Art 30(b).

⁴²⁴ Implementing Regulation, Art 83(j). See, for a similar provision, UCITS Implementing Directive (n 220), Art 31(1)(a).

⁴²⁵ Implementing Regulation, Art 83(k).

select the third party and the steps envisaged to monitor the activities carried out by the selected third party.⁴²⁶

N. Money laundering and financing of terrorism

- 1.384** The agreement must contain information on the tasks and responsibilities of the parties to the contract in respect of obligations relating to the prevention of money laundering and the financing of terrorism.⁴²⁷

O. Cash accounts

- 1.385** The agreement must contain information on (i) all cash accounts opened in the name of the AIF or in the name of the AIFM on behalf of the AIF and (ii) the procedures ensuring that the depositary will be informed at the opening of any new account in the name of the AIF or in the name of the AIFM acting on its behalf.⁴²⁸

P. Escalation procedures

- 1.386** The agreement must contain details on the depositary's escalation procedure(s), including the identification of the persons to be contacted within the AIF and, as the case may be, the AIFM by the depositary when it launches such a procedure.⁴²⁹

Q. Insolvency risk to third party to whom safe-keeping is delegated

- 1.387** The agreement must contain a commitment by the depositary to notify the AIFM when it becomes aware that the segregation of assets is not, or is no longer, sufficient to ensure protection from insolvency of a third party, to whom safe-keeping functions are delegated pursuant to Article 21(11) of the AIFMD, in a specific jurisdiction.⁴³⁰

R. Depositary enquiries

- 1.388** The agreement must contain the procedures ensuring that the depositary, in respect of its duties, has the ability to enquire into the conduct of the AIFM and, as the case may be, the AIF and to assess the quality of information transmitted including by way of having access to the books of the AIF and, as the case may be, the AIFM or by way of onsite visits.⁴³¹

S. Reviewing depositary performance

- 1.389** The agreement must contain the procedures ensuring that the AIFM and, as the case may be, the AIF can review the performance of the depositary in respect of the depositary's contractual obligations.⁴³²

T. Specification of national law

- 1.390** The national law applicable to the contract appointing the depositary and any subsequent agreement must be specified.⁴³³

⁴²⁶ Implementing Regulation, Art 83(l).

⁴²⁷ Implementing Regulation, Art 83(m). See, for a similar provision, UCITS Implementing Directive (n 220), Art 31(c).

⁴²⁸ Implementing Regulation, Art 83(n).

⁴²⁹ Implementing Regulation, Art 83(o).

⁴³⁰ Implementing Regulation, Art 83(p).

⁴³¹ AIFMD Implementing Regulation, Art 83(q). See, for a similar provision, UCITS Implementing Directive (n 220), Art 39(e).

⁴³² Implementing Regulation, Art 83(r). See, for a similar provision, UCITS Implementing Directive (n 220), Art 30(f).

⁴³³ Implementing Regulation, Art 83(6). Article 34 of the UCITS Implementing Directive (n 220) provides that the agreement should specify that the law of the UCITS home Member State applies to the agreement.

4. Entities that may act as depositary

A. General

Given the importance of the custody function, the depositary must be a credit institution **1.391** having its registered office in the Union and authorized in accordance with the Banking Directive (revised), or an investment firm having its registered office in the Union, subject to capital adequacy requirements in accordance with Article 20(1) of the Capital Requirements Directive, including capital requirements for operational risks and authorized in accordance with MiFID and which also provides the ancillary service of safe-keeping and administration of financial instruments for the account of clients in accordance with MiFID, Annex 1, section B, point (1). Such investment firms must in any case have own funds not less than the amount of initial capital referred to in Article 9 of the Capital Requirements Directive; or another category of institution that is subject to prudential regulation and ongoing supervision and which, on 21 July 2011, falls within the categories of institution determined by Member States to be eligible to be a depositary under Article 23(3) of the UCITS Directive.⁴³⁴

B. Depositaries for non-EU AIFs

For non-EU AIFs only, the depositary may also be a credit institution or any other entity of the same nature as the entities set out in paragraph 1.391, as long as it is subject to effective prudential regulation and supervision which have the same effect as Union law and are effectively enforced.⁴³⁵ **1.392**

C. Depositaries for private equity, venture capital funds, and real estate funds

For AIFs (i) that have no redemption rights exercisable during the period of five years from the date of the initial investments and (ii) that, in accordance with their core investment policy, (a) generally do not invest in assets that must be held in custody in accordance with the AIFMD **1.393**

⁴³⁴ AIFMD, Art 21(3), first paragraph, AIFMD. See also AIFMD, recital (34). The UCITS Directive (n 2) contains similar provisions: see Art 33(2) and (3). See, in a similar vein, Art 23(2) of the European Commission's proposal for UCITS V (n 385).

⁴³⁵ AIFMD, Art 21(3), second paragraph. See, further, AIFMD, Art 21(6). See also AIFMD, recital (34), *in fine*. The appointment of a depositary established in a third country must, at all times, be subject to the following conditions. (i) the competent authorities of the Member States in which the units or shares of the non-EU AIF are intended to be marketed, and, in so far as different, of the home Member State of the AIFM, have signed cooperation and exchange of information arrangements with the competent authorities of the depositary. (ii) The depositary is subject to effective prudential regulation, including minimum capital requirements and supervision, which have the same effect as Union law and are effectively enforced. (iii) The third country where the depositary is established is not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force (FATF). (4) The Member States in which the units or shares of the non-EU AIF are intended to be marketed, and, in so far as different, the home Member State of the AIFM, have signed an agreement with the third country where the depositary is established which fully complies with the standards laid down in Art 26 of the OECD Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters including any multilateral tax agreements. (iv) The depositary must by contract be liable to the AIF or to the investors of the AIF, consistently with AIFMD, Art 21(12) and (13) (see paras 1.445–1.461), and must expressly agree to comply with Art 21(11) (see paras 1.429–1.442). See AIFMD, Art 21(6), first paragraph and recital (35). AIFMD, Art 21(6)(b) (effectiveness of prudential regulation and supervision applicable to a depositary in a third country, whether it has the same effect as that provided for under Union law and its effective enforcement) is specified in more detail in the Implementing Regulation, Art 84. Where a competent authority of another Member State disagrees with the assessment made on the application of the points set out under (1), (3) or (5) by the competent authorities of the home Member State of the AIFM, the competent authorities concerned may refer the matter to ESMA, which may act in accordance with the powers conferred on it under ESMA Regulation (n 29), Art 19: AIFMD, Art 21(6), second paragraph. See also recital (35).

or (b) generally invest in issuers or non-listed companies in order potentially to acquire control over such companies in accordance with the Directive, such as private equity, venture capital funds, and real estate funds, Member States may allow a notary, lawyer, registrar or another entity to be appointed to carry out depositary functions.⁴³⁶

D. AIFMs

- 1.394** In order to avoid conflicts of interest between the depositary, the AIFM, and/or the AIF, and/or its investors, an AIFM may *not* act as depositary.⁴³⁷

E. Prime brokers

- 1.395** The AIFMD takes account of the fact that many AIFs, and in particular hedge funds, make use of a prime broker. Prime brokerage services comprise central settlement and financing services. The industry grew out of brokers who offered to act as central settlement agents and settle client transactions (cash transactions as well as futures and fx forward transactions) that are executed away from the prime broker, but given up to the prime broker for settlement. The prime brokers also offer financing services, lending cash or securities to the fund so that it may settle its leveraged and 'short' positions, respectively, with the borrowed cash or securities.
- 1.396** The benefit of using a prime broker is that all exposures can be centralized in the prime broker, which permits netting and a much more efficient use of collateral. To maximize service efficiency and facilitate collateralization, the prime broker will usually act as custodian to the fund so that all its assets are held by the prime broker and can be used as collateral. Typically, the fund will permit the prime broker to 'use', ie borrow, the custodied assets from the fund, also known as re-hypothecation, permitting a much lower financing rate to the fund, which brings down the expense ratio for the investors. Ergo, if the prime broker cannot act as depositary to an AIF, it will have to separate the custody function from the prime broker function, which would undermine efficiency and raise the financing rate for the AIF substantially.
- 1.397** The AIFMD ensures that AIFs may continue to use the function of prime brokers. However, unless (i) it has functionally and hierarchically separated the performance of its depositary functions from its business as prime broker and (ii) the potential conflicts of interest are properly identified, managed, and disclosed to the investors of the AIF, no prime broker should be appointed as a depositary, since prime brokers act as counterparties to AIFs and therefore cannot at the same time act in the best interest of the AIF as is required of a depositary.
- 1.398** Depositaries should be able to delegate custody tasks to one or more prime brokers or other third parties in accordance with the AIFMD. In addition to the delegated custody tasks prime brokers should be allowed to provide prime brokerage services to the AIF. Those prime brokerage services should not form part of the delegation arrangement.⁴³⁸

⁴³⁶ AIFMD, Art 21(3), last paragraph. See also AIFMD, recital (34). The depositary functions should be part of professional or business activities in respect of which the appointed entity is subject to mandatory professional registration recognized by law or to legal or regulatory provisions or rules of professional conduct and can provide sufficient financial and professional guarantees to enable it to perform the relevant depositary functions and meet the commitments inherent in those functions effectively. This takes account of current practice for certain types of closed-ended funds: Art 21(3), last paragraph. See also recital (34).

⁴³⁷ AIFMD, Art 21(4)(a).

⁴³⁸ AIFMD, Art 21(4)(b). See also recital (43).

If a prime broker has been appointed, the AIFM must ensure that from the date of that appointment an agreement is in place pursuant to which the prime broker is subject to extensive reporting obligations towards the depositary with respect to the value of the assets the safekeeping of which has been delegated to the prime broker in accordance with the AIFMD.⁴³⁹ **1.399**

5. Location depositary

For EU AIFs, the depositary must be established in the home Member State of the AIF.⁴⁴⁰ **1.400**

For non-EU AIFs, the depositary must be established (i) in the third country where the AIF is established, (ii) in the home Member State of the AIFM managing the AIF, or (iii) in the Member State of reference of the AIFM managing the AIF.⁴⁴¹ **1.401**

6. Monitoring by depositary of AIF's cash flows

A. Duties of the depositary

The depositary must in general ensure that the AIF's cash flows are properly monitored,⁴⁴² and must at least ensure: **1.402**

- (a) that all payments made by or on behalf of investors upon the subscription of units or shares of an AIF have been received;⁴⁴³
- (b) that all cash of the AIF has been booked in cash accounts opened (i) in the name of the AIF, (ii) in the name of the AIFM acting on behalf of the AIF, or (iii) in the name of the depositary acting on behalf of the AIF⁴⁴⁴ at: (1) a central bank; (2) a credit institution authorized in accordance with Directive 2000/12/EC;⁴⁴⁵ (3) a bank authorized in a third country; or (4) as regards cash held in a third country, another entity of the same nature, in the relevant market where cash accounts are required;⁴⁴⁶
- (c) to implement effective and proper procedures to reconcile all cash flow movements and perform such reconciliations on a daily basis or, in the case of infrequent cash movements, when such cash flow movements occur;⁴⁴⁷

⁴³⁹ See Implementing Regulation, Art 91.

⁴⁴⁰ AIFMD, Art 21(5)(a). See also recital (35).

⁴⁴¹ AIFMD, Art 21(5)(b). See also recital (35).

⁴⁴² AIFMD, Art 21(7), first paragraph. In a similar vein, see Art 22(4), opening words of the European Commission's proposal for UCITS V (n 385).

⁴⁴³ AIFMD, Art 21(7), first paragraph. See also Implementing Regulation, Art 87. In a similar vein, see Art 22(4), opening words of the European Commission's proposal for UCITS V (n 385).

⁴⁴⁴ Where the cash accounts are opened in the name of the depositary acting on behalf of the AIF, no cash of the entity referred to under points (1)–(4), and none of the depositary's own cash may be booked on such accounts: AIFMD, Art 21(7), second paragraph. In a similar vein, see Art 22(4), last paragraph of the European Commission's proposal for UCITS V (n 385).

⁴⁴⁵ Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (OJ 2000 L126/1).

⁴⁴⁶ Provided that such entity is subject to effective prudential regulation and supervision which have the same effect as Union law and are effectively enforced in accordance with the principles set out in Art 16 of the MiFID Implementing Directive (n 237) (safeguarding of client financial instruments and funds). See AIFMD, Art 21(7), first paragraph. See also AIFMD, recital (37) and Implementing Regulation, Art 86(a). See, for similar provisions, Art 22(4)(a)–(c), of the European Commission's proposal for UCITS V (n 385).

⁴⁴⁷ Implementing Regulation, Art 86(b).

- (d) to implement appropriate procedures to identify at the close of business day significant cash flows and in particular those which could be inconsistent with the AIF's operations;⁴⁴⁸
- (e) to review periodically the adequacy of those procedures, including through a full review of the reconciliation process at least once a year and ensuring that the cash accounts opened in the name of the AIF, in the name of the AIFM acting on behalf of the AIF, or in the name of the depositary acting on behalf of the AIF are included in the reconciliation process;⁴⁴⁹
- (f) to monitor on an ongoing basis the outcomes of the reconciliations and actions taken as a result of any discrepancies identified by the reconciliation procedures and notify the AIFM if an irregularity has not been rectified without undue delay and also the competent authorities if the situation cannot be clarified and, as the case may be, or corrected;⁴⁵⁰ and
- (g) to check the consistency of its own records of cash positions with those of the AIFM. The AIFM must ensure that all instructions and information related to a cash account opened with a third party are sent to the depositary, so that the depositary is able to perform its own reconciliation procedure.⁴⁵¹

B. Duties of the AIFM

a. Cash accounts

- 1.403** The AIFM must ensure that the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations regarding the cash accounts maintained or opened (i) in the name of the AIF, (ii) in the name of the AIFM acting on behalf of the AIF, or (iii) in the name of the depositary acting on behalf of the AIF.⁴⁵² The depositary must have access to all information regarding the AIF's cash accounts.⁴⁵³

b. Payments regarding subscription of units or shares

- 1.404** The AIFM must ensure that the depositary is provided with information about payments made by or on behalf of investors upon the subscription of units or shares of an AIF the moment (i) the AIFM, (ii) the AIF, or (iii) a party acting on behalf of it (such as a transfer agent) receives the payments or an order from the investor. The AIFM must ensure that the depositary gets all further relevant information it needs to make sure that the payments are then booked in cash accounts opened (a) in the name of the AIF, or (b) in the name of the AIFM acting on behalf of the AIF, or (c) in the name of the depositary.

⁴⁴⁸ Implementing Regulation, Art 86(c).

⁴⁴⁹ Implementing Regulation, Art 86(d).

⁴⁵⁰ Implementing Regulation, Art 86(e).

⁴⁵¹ Implementing Regulation, Art 86(f).

⁴⁵² Implementing Regulation, Art 85(1).

⁴⁵³ Implementing Regulation, Art 85(2), opening words. To that end, and to have a clear overview of all the AIF's cash flows, at least the following conditions must be fulfilled: (a) the depositary must be informed, upon its appointment, of all existing cash accounts opened in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF; (b) the depositary must be informed at the opening of any new cash account by the AIF or the AIFM acting on behalf of the AIF; and (c) the depositary must be provided with all information related to the cash accounts opened at a third party entity, directly by those third parties. See Implementing Regulation, Art 85, opening words, and under (a)–(c).

7. *Safe-keeping of financial instruments to be held in custody***A. Financial instruments to be held in custody**

Financial instruments of the AIF or the AIFM acting on behalf of the AIF that can be held in custody must be entrusted to the depositary for safe-keeping. The depositary must hold in custody (i) all financial instruments that can be registered in a financial instruments account opened in the depositary's books⁴⁵⁴ and (ii) all financial instruments that can be physically delivered to the depositary.⁴⁵⁵ **1.405**

B. Proper registration

The depositary must ensure that all financial instruments that can be registered in a financial instruments account opened in the depositary's books are registered in the depositary's books within segregated accounts in accordance with the principles set out in Article 16 of the MiFID Implementation Directive (safeguarding of client financial instruments and funds), opened in the name of the AIF or the AIFM acting on behalf of the AIF, so that they can be clearly identified as belonging to the AIF in accordance with the applicable law at all times.⁴⁵⁶ **1.406**

C. Records and segregated accounts

Records and segregated accounts must be maintained in a way that ensures their accuracy, and must in particular record the correspondence to the financial instruments and cash held for AIFs.⁴⁵⁷ **1.407**

D. Reconciliations

Reconciliations must be conducted on a regular basis between the depositary's internal accounts and records and those of any third party to whom custody functions are delegated.⁴⁵⁸ **1.408**

⁴⁵⁴ AIFMD, Art 21(8)(a)(i), first part. Similarly, see Art 22(5)(a)(i), first part of the European Commission's proposal for UCITS V (n 385). Financial instruments belonging to the AIF or the AIFM acting on behalf of the AIF which are not able to be physically delivered to the depositary must be included in the scope of the depositary's custody duties if they fulfil all of the following criteria: (a) they are transferable securities including those which embed derivatives as referred to in Art 51(3), final sub-paragraph of the UCITS Directive (n 2) and Art 10 of Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions (OJ 2007 L79/11), money market instruments, or units of collective investment undertakings; (b) they are capable of being registered or held in an account directly or indirectly in the name of the depositary. See Implementing Regulation, Art 88(1). Financial instruments which, in accordance with applicable national law, are only directly registered in the name of the AIF with the issuer itself or its agent, such as a registrar or a transfer agent, will not be held in custody. See Implementing Regulation, Art 88(2).

⁴⁵⁵ AIFMD, Art 21(8)(a)(i), second part. In a similar vein, see Art 22(5)(a)(i), second part of the European Commission's proposal for UCITS V (n 385). Financial instruments belonging to the AIF or the AIFM acting on behalf of the AIF which are able to be physically delivered to the depositary must always be included in the scope of custody duties of the depositary. See Implementing Regulation, Art 88(3).

⁴⁵⁶ AIFMD, Art 21(8)(a)(ii). See also Implementing Regulation, Art 89(1)(a). In a similar vein, see Art 22(5)(a)(ii) of the European Commission's proposal for UCITS V (n 385).

⁴⁵⁷ Implementing Regulation, Art 89(1)(b).

⁴⁵⁸ Implementing Regulation, Art 89(1)(c).

E. Due care

- 1.409** Due care must be exercised in relation to the financial instruments held in custody to ensure a high standard of investor protection.⁴⁵⁹

F. Custody risks throughout the custody chain

- 1.410** All relevant custody risks throughout the custody chain must be assessed and monitored and the depositary must inform the AIFM of any material risk identified.⁴⁶⁰

G. Fraud, poor administration, inadequate registering, or negligence

- 1.411** The depositary must introduce adequate organizational arrangements to minimize the risk of the loss or diminution of the financial instruments, or of rights in connection with those financial instruments as a result of fraud, poor administration, inadequate registering, or negligence.⁴⁶¹

H. Verification of ownership rights

- 1.412** The depositary must verify the AIF's ownership right or the ownership right of the AIFM acting on behalf of the AIF over the assets.⁴⁶²

I. Delegation of custody functions

- 1.413** Where a depositary has delegated its custody functions to a third party it remains subject to the requirements set out in sections C–F. It must also ensure that the third party complies with the requirements set out in sections C–H and the segregation obligations laid down in Article 99 of the Implementing Regulation.

J. Look-through approach

- 1.414** The depositary's safe-keeping duties apply on a look-through basis to underlying assets held by financial and, as the case may be, legal structures controlled directly or indirectly by the AIF or the AIFM acting on behalf of the AIF.
- 1.415** This does not apply to fund of funds structures or master-feeder structures where the underlying funds have a depositary which keeps in custody the assets of these funds.⁴⁶³

8. Safe-keeping of assets other than financial instruments that can be held in custody

A. General

- 1.416** For assets other than financial instruments that can be held in custody, the depositary (i) must verify the ownership of the AIF or the AIFM acting on behalf of the AIF of such assets and (ii) must maintain a record of those assets for which it is satisfied that the AIF or the AIFM acting on behalf of the AIF holds the ownership of such assets. The assessment whether the AIF or the AIFM acting on behalf of the AIF holds the ownership must be based on information

⁴⁵⁹ Implementing Regulation, Art 89(1)(d).

⁴⁶⁰ Implementing Regulation, Art 89(1)(e).

⁴⁶¹ Implementing Regulation, Art 89(1)(f).

⁴⁶² Implementing Regulation, Art 89(1)(g).

⁴⁶³ Implementing Regulation, Art 89(3).

or documents provided by the AIF or AIFM and, where available, on external evidence. The depositary must keep its record up to date.⁴⁶⁴

B. Provision of information to depositary

An AIFM must provide the depositary, upon commencement of its duties and on an ongoing basis, with all relevant information the depositary needs in order to comply with its safe-keeping obligations with respect to assets other than financial instruments that can be held in custody, and ensure that the depositary is being provided with all relevant information by third parties.⁴⁶⁵ **1.417**

C. Access to information

The depositary must have access without undue delay to all relevant information it needs in order to perform its ownership verification and record-keeping duties, including relevant information to be provided to the depositary by third parties.⁴⁶⁶ **1.418**

D. Reliable information

The depositary must possess sufficient and reliable information for it to be satisfied of the AIF's ownership right over the assets, or of the ownership right of the AIFM acting on behalf of the AIF.⁴⁶⁷ **1.419**

E. Records

The depositary must maintain a record of those assets for which it is satisfied that the AIF or the AIFM acting on behalf of the AIF holds the ownership. In order to comply with this obligation, the depositary must: (i) register in its record, in the name of the AIF, assets, including their respective notional amounts, for which it is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership of those assets; and (ii) be able to provide at any time a comprehensive and up-to-date inventory of the AIF's assets, including their respective notional amounts.⁴⁶⁸ **1.420**

F. Verification procedures

A depositary must ensure that the AIFM has and implements appropriate procedures to verify that the assets acquired by its AIF are appropriately registered in the name of the AIF or in the name of the AIFM acting on behalf of the AIF, and to check consistency between the positions in the AIFM's records and the assets for which the depositary is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership. The AIFM must ensure that all instructions and relevant information relating to the AIF's assets are sent to the **1.421**

⁴⁶⁴ AIFMD, Art 21(8)(b). In a similar vein, see Art 22(5)(b) of the European Commission's proposal for UCITS V (n 385).

⁴⁶⁵ Implementing Regulation, Art 90(1).

⁴⁶⁶ Implementing Regulation, Art 90(2)(a).

⁴⁶⁷ Implementing Regulation, Art 90(2)(b).

⁴⁶⁸ Implementing Regulation, Art 90(2)(c)(i), (ii). For the purpose of Art 90(2)(c)(ii), the depositary must: (i) ensure that there are procedures in place to prevent registered assets being assigned, transferred, exchanged, or delivered without the depositary or its delegate having been informed of such transactions; or (ii) have access without undue delay to documentary evidence of each transaction and positions from the relevant third party. The AIFM must ensure that the relevant third party provides the depositary without undue delay with certificates or other documentary evidence every time there is a sale or acquisition of assets or a corporate action resulting in the issue of financial instruments, and at least once a year. See the Implementing Regulation, Art 90(2)(c), last paragraph.

depository, so that the depository is able to perform its own verification or reconciliation procedure.⁴⁶⁹

G. Escalation procedure

- 1.422** A depository must set up and implement an escalation procedure for situations where an anomaly is detected, including the notification of the AIFM and of the competent authorities if the situation cannot be clarified and, as the case may be, corrected.⁴⁷⁰

H. Look-through approach

- 1.423** The depository's safe-keeping duties apply on a look-through basis to underlying assets held by financial and, as the case may be, legal structures established by the AIF or the AIFM acting on behalf of the AIF for the purposes of investing in the underlying assets which are controlled directly or indirectly by the AIF or by the AIFM acting on behalf of the AIF.
- 1.424** This does not apply to fund of funds structures and master-feeder structures where the underlying funds have a depository which provides ownership verification and record-keeping functions for the fund's assets.⁴⁷¹

9. Oversight of operational functions

- 1.425** The depository must also:

- (a) ensure that the sale, issue, repurchase, redemption, and cancellation of units or shares of the AIF are carried out in accordance with the applicable national law and the AIF rules or instruments of incorporation;⁴⁷²
- (b) ensure that the value of the units or shares (NAV) of the AIF is calculated in accordance with the applicable national law, the AIF rules, or instruments of incorporation and the procedures laid down in Article 15 of the AIFMD;⁴⁷³
- (c) carry out the instructions of the AIFM, unless they conflict with the applicable national law or the AIF rules or instruments of incorporation;⁴⁷⁴
- (d) ensure that in transactions involving the AIF's assets any consideration is remitted to the AIF within the usual time limits;⁴⁷⁵
- (e) ensure that an AIF's income is applied in accordance with the applicable national law and the AIF rules or instruments of incorporation.⁴⁷⁶

⁴⁶⁹ Implementing Regulation, Art 90(3).

⁴⁷⁰ Implementing Regulation, Art 90(4).

⁴⁷¹ Implementing Regulation, Art 90(5).

⁴⁷² AIFMD, Art 21(9)(a). See, for a similar provision, Art 32(3)(a) of the UCITS Directive (n 2); see also Art 22(3)(a) of the European Commission's proposal for UCITS V (n 385). See Implementing Regulation, Art 93 for a further specification of AIFMD, Art 21(9)(a).

⁴⁷³ AIFMD, Art 21(9)(b). See, for further specifications, Implementing Regulation, Art 94. In a similar vein, see Art 22(3)(b) of the European Commission's proposal for UCITS V (n 385).

⁴⁷⁴ AIFMD, Art 21(9)(c). See, for further specifications, Implementing Regulation, Art 95. In a similar vein, see Art 22(3)(c) of the European Commission's proposal for UCITS V (n 385).

⁴⁷⁵ AIFMD, Art 21(9)(d). See, for a similar provision, UCITS Directive (n 2), Art 32(3)(b)(f). See Implementing Regulation, Art 96 for a further specification of AIFMD, Art 21(9)(d). In a similar vein, see Art 22(3)(d) of the European Commission's proposal for UCITS V (n 385).

⁴⁷⁶ AIFMD, Art 21(9)(e). See, for a similar provision, Art 32(3)(c) of the UCITS Directive (n 2); see also Art 22(3)(e) of the European Commission's proposal for UCITS V (n 385). See Implementing Regulation, Art 97 for a further specification of AIFMD, Art 21(9)(e). Note that the duties set out in Art 21(9) are in general

10. *Duty to act in the best interest of the AIF and its investors*

In the context of their respective roles, the AIFM and the depositary must act honestly, fairly, professionally, independently, and in the interest of the AIF and its investors.⁴⁷⁷ **1.426**

11. *Conflicts of interest*

A depositary must not carry out activities with regard to the AIF or the AIFM on behalf of the AIF that may create conflicts of interest between the AIF, the investors in the AIF, the AIFM, and itself, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored, and disclosed to the investors of the AIF.⁴⁷⁸ **1.427**

12. *Re-use of assets/rehypothecation by the depositary*

The assets of the AIF may not be re-used by the depositary without the prior consent of the AIF or the AIFM acting on behalf of the AIF.⁴⁷⁹ **1.428**

13. *Delegation of safe-keeping functions*

A. Delegation of safe-keeping functions only

A depositary may not delegate its functions, except for the safe-keeping of assets to a third party which, in its turn, may delegate that function.⁴⁸⁰ **1.429**

This means that a depositary may not delegate the monitoring of cash flows or functions such as the calculation of the NAV. This means that the depositary remains in charge with respect to the transactions performed on behalf of the AIFs.⁴⁸¹ **1.430**

Delegation and sub-delegation of safe-keeping of assets must be objectively justified and are subject to strict requirements in relation to the suitability of the third party entrusted with the delegated function, and in relation to the due skill, care, and diligence the depositary must employ to select, appoint, and review that third party.⁴⁸² **1.431**

B. Omnibus accounts

A third party to whom the safe-keeping of assets is delegated must be able to maintain a common segregated account for multiple AIFs, a so-called ‘omnibus account’.⁴⁸³ **1.432**

terms further specified in Implementing Regulation, Art 92. In summary, this provision provides that: (i) the depositary must make a risk assessment of the AIF’s strategy and the AIF’s organization with a view to defining oversight procedures; (ii) the depositary must perform ex-post controls and verifications of relevant processes and procedures; (iii) the depositary establishes clear and comprehensive escalation procedures; and (iv) the AIFM provides the depositary with all relevant information.

⁴⁷⁷ AIFMD, Art 21(10), first paragraph. See also AIFMD, recital (38).

⁴⁷⁸ AIFMD, Art 21(10), second paragraph.

⁴⁷⁹ AIFMD, Art 21(10), third paragraph.

⁴⁸⁰ AIFMD, Art 21(11), first paragraph (delegation safe-keeping); AIFMD, Art 21(11), fourth paragraph (sub-delegation safe-keeping). In a similar vein, see Art 22(7) of the European Commission’s proposal for UCITS V (n 385).

⁴⁸¹ See also Wymeersch, ‘The European Alternative Investment Fund Management Directive’ (n 64) 464.

⁴⁸² AIFMD, recital (39).

⁴⁸³ AIFMD, recital (40).

C. Entrusting functions to securities settlement systems

- 1.433** Entrusting the custody of assets to the operator of a securities settlement system as designated for the purposes of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems⁴⁸⁴ or entrusting the provision of similar services to third-country securities settlement systems are *not* considered to be a delegation of custody functions.⁴⁸⁵

D. Delegation of supporting tasks

- 1.434** The strict limitations and requirements to which the delegation of tasks by the depositary is subject apply to the delegation of its specific functions as a depositary, namely the monitoring of the cash flow (which may not be delegated), the safe-keeping of assets (which may be delegated), and the oversight functions (which may not be delegated).
- 1.435** Delegation of supporting tasks that are linked to its depositary tasks, such as administrative or technical functions performed by the depositary as a part of its depositary tasks, is *not* subject to the specific limitations and requirements set out in the AIFMD.⁴⁸⁶

E. Conditions for delegation

a. General

- 1.436** The depositary may delegate to third parties its safe-keeping functions subject to the following conditions.

b. No intention of avoiding AIFMD

- 1.437** The depositary's tasks must not be not delegated with the intention of avoiding the requirements of the AIFMD.⁴⁸⁷

c. Objective reasons for delegation

- 1.438** The depositary must demonstrate that there is an objective reason for the delegation.⁴⁸⁸

d. Selection, appointment, review, and monitoring third parties

- 1.439** The depositary must exercise all due skill, care, and diligence in the selection and appointment of any third party to whom it wishes to delegate parts of its tasks, and exercise all due skill, care, and diligence in the periodic review and ongoing monitoring of any third party to whom it has delegated parts of its tasks and of the arrangements of the third party in respect of the matters delegated to it.⁴⁸⁹

⁴⁸⁴ OJ 1998 L166/45.

⁴⁸⁵ AIFMD, Art 21(11), fifth paragraph and recital (41). In a similar vein, see Art 22(7), sixth paragraph of the European Commission's proposal for UCITS V (n 385).

⁴⁸⁶ AIFMD, recital (42).

⁴⁸⁷ AIFMD, Art 21(11)(a). In a similar vein, see Art 22(7), second paragraph, (a) of the European Commission's proposal for UCITS V (n 385).

⁴⁸⁸ AIFMD, Art 21(11)(b). In a similar vein, see Art 22(7), second paragraph, (b) of the European Commission's proposal for UCITS V (n 385).

⁴⁸⁹ AIFMD, Art 21(11)(c). This due diligence duty is specified in detail in Implementing Regulation, Art 98. In a similar vein, see Art 22(7), second paragraph, (c) of the European Commission's proposal for UCITS V (n 385).

e. Requirements during the performance of the tasks delegated

The depositary must ensure that the third party meets the following conditions at all times during the performance of the tasks delegated to it: **1.440**

- (a) the third party has the structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF or the AIFM acting on behalf of the AIF which have been entrusted to it;⁴⁹⁰
- (b) for custody of financial instruments, the third party is subject to effective prudential regulation (including minimum capital requirements) and supervision in the jurisdiction concerned and to an external periodic audit to ensure that the financial instruments are in its possession;⁴⁹¹
- (c) the third party segregates the assets of the depositary's clients from its own assets and from the assets of the depositary in such a way that they can at any time be clearly identified as belonging to clients of a particular depositary;⁴⁹²
- (d) the third party does not make use of the assets without the prior consent of the AIF or the AIFM acting on behalf of the AIF and prior notification to the depositary;⁴⁹³ and
- (e) the third party complies with the general obligations and prohibitions set out in Article 21(8) and (10) (safe-keeping of assets and duty to act in the best interest of the AIF and its investors: see paragraphs 1.405 to 1.424 and paragraphs 1.426 to 1.428).⁴⁹⁴

F. Conditions for delegation to a third party entity

As a general rule, the depositary may delegate its custody functions to a third party provided that the third party is subject to effective prudential regulation and supervision in the jurisdiction concerned for custody of financial instruments and to an external periodic audit to ensure that the financial instruments are in its possession.⁴⁹⁵ However, where the law of a third country requires that certain financial instruments be held in custody by a local entity and no local entities satisfy these delegation requirements,⁴⁹⁶ the depositary may delegate its functions to such a local entity only to the extent required by the law of the third country and only for as long as there are no local entities that satisfy the delegation requirements, and subject to the following requirements: **1.441**

- (a) the investors of the relevant AIF must be duly informed that such delegation is required due to legal constraints in the law of the third country and of the circumstances justifying the delegation, prior to their investment; and

⁴⁹⁰ AIFMD, Art 21(11)(d)(i). In a similar vein, see Art 22(7), third paragraph, (a) of the European Commission's proposal for UCITS V (n 385).

⁴⁹¹ AIFMD, Art 21(11)(d)(ii). In a similar vein, see Art 22(7), third paragraph, (b), (c) of the European Commission's proposal for UCITS V (n 385).

⁴⁹² AIFMD, Art 21(11)(d)(iii). See, for a further specification of the segregation obligation, Implementing Regulation, Art 99, applying *mutatis mutandis* when the third party further delegates safe-keeping functions (Implementing Regulation, Art 99(3)). In a similar vein, see Art 22(7), third paragraph, (d) of the European Commission's proposal for UCITS V (n 385).

⁴⁹³ AIFMD, Art 21(11)(d)(iv).

⁴⁹⁴ AIFMD, Art 21(11)(d)(v). In a similar vein, see Art 22(7), third paragraph, (f) of the European Commission's proposal for UCITS V (n 385).

⁴⁹⁵ AIFMD, Art 21(11)(d)(ii). See also para 1.440.

⁴⁹⁶ This is true for certain emerging markets. See also Wymeersch, 'The European Alternative Investment Fund Management Directive' (n 64) 464.

- (b) the AIF, or the AIFM on behalf of the AIF, must instruct the depositary to delegate the custody of such financial instruments to such local entity.⁴⁹⁷

G. Conditions for sub-delegation

- 1.442** The third party may, in turn, sub-delegate safe-keeping functions, subject to the same requirements (see paragraphs 1.436 to 1.441). In such a case, Article 21(13) of the AIFMD on the depositary's liability in the case of delegation of functions applies *mutatis mutandis* to the relevant parties.⁴⁹⁸

14. Liability of depositary

A. General

- 1.443** The depositary is liable for the losses suffered by the AIFM, the AIF, and the investors. The AIFMD distinguishes between the loss of financial instruments held in custody, and any other losses. The strict depositary liability regime is one of the most controversial elements of the AIFMD.⁴⁹⁹

- 1.444** The AIFMD's liability provisions raise general questions about their legal nature and operation.⁵⁰⁰

B. Liability for loss of financial instruments

a. General

- 1.445** The depositary is liable to the AIF or to the investor of the AIF for the loss of financial instruments by (i) the depositary or (ii) a third party to whom the custody of financial instruments held in custody has been delegated.⁵⁰¹ In the case of such a loss, the depositary must return a financial instrument of identical type or the corresponding amount to the AIF or the AIFM acting on behalf of the AIF without undue delay.⁵⁰²

b. Loss of a financial instrument held in custody

- 1.446** Loss of a financial instrument held in custody is deemed to have taken place when, in relation to a financial instrument held in custody by the depositary or by a third party to whom the custody of financial instruments has been delegated, any of the following conditions

⁴⁹⁷ AIFMD, Art 21(11), third paragraph, (a), (b). In a similar vein, see Art 22(7), fourth paragraph, (a), (b) of the European Commission's proposal for UCITS V (n 385).

⁴⁹⁸ AIFMD, Art 21(11), fourth paragraph. In a similar vein, see Art 22(7), fifth paragraph, (a) of the European Commission's proposal for UCITS V (n 385).

⁴⁹⁹ See UCITS Directive (n 2), Art 24, first paragraph for the liability regime applying to UCITS depositaries: 'A depositary shall, in accordance with the national law of the UCITS home Member State, be liable to the management company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them'. Cf. UCITS Directive (n 2), Art 34. See also Art 24 of the European Commission's proposal for UCITS V (n 385).

⁵⁰⁰ See paras 1.13–1.22.

⁵⁰¹ AIFMD, Art 21(12), first paragraph. In a similar vein, see Art 24(1), first paragraph of the European Commission's proposal for UCITS V (n 385).

⁵⁰² AIFMD, Art 21(12), second paragraph. In a similar vein, see Art 24(1), second paragraph of the European Commission's proposal for UCITS V (n 385).

is met, irrespective of whether they are the result of fraud, negligence, or non-intentional behaviour.⁵⁰³

- (a) a stated right of ownership of the AIF is demonstrated not to be valid because it either ceased to exist or never existed;⁵⁰⁴
- (b) the AIF has been definitively deprived of its right of ownership over the financial instrument;⁵⁰⁵ and
- (c) the AIF is definitively unable to directly or indirectly dispose of the financial instrument.⁵⁰⁶

In the event of insolvency of the third party to whom the custody of financial instruments held in custody has been delegated, the loss of a financial instrument held in custody must be ascertained by the AIFM as soon as one of the conditions set out in paragraph 1.446 is met with certainty. Such certainty exists at the latest at the end of the insolvency proceedings. The AIFM and the depositary must closely monitor the insolvency proceedings to determine whether all or part of the financial instruments entrusted to the third party to whom the custody of financial instruments has been delegated are effectively lost.⁵⁰⁷ **1.447**

The ascertainment by the AIFM of the loss of a financial instrument must follow a documented process readily available to the competent authorities. Once a loss is ascertained it must be notified immediately to investors in a durable medium.⁵⁰⁸ **1.448**

c. External events beyond reasonable control

The depositary is *not* liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.⁵⁰⁹ In this context, a depositary should not, for example, be able to rely on internal situations such as a fraudulent act by an employee to discharge itself of liability.⁵¹⁰ **1.449**

The depositary is not liable provided it can prove that all the following conditions are met: **1.450**

- (a) The event which led to the loss is not the result of any act or omission of the depositary or of a third party to whom the custody of financial instruments held in custody has been delegated.⁵¹¹
- (b) The depositary could not have reasonably prevented the occurrence of the event which led to the loss despite the adoption of all precautions incumbent on a diligent depositary as reflected in common industry practice.⁵¹²

⁵⁰³ Implementing Regulation, Art 100(1), opening words, read in conjunction with Art 100(5).

⁵⁰⁴ Implementing Regulation, Art 100(1)(a).

⁵⁰⁵ Implementing Regulation, Art 100(1)(b). There is no loss of a financial instrument held in custody where an AIF is definitively deprived of its right of ownership in respect of a particular instrument, but this instrument is substituted by or converted into another financial instrument or instruments. See Art 100(3).

⁵⁰⁶ Implementing Regulation, Art 100(1)(c).

⁵⁰⁷ Implementing Regulation, Art 100(4).

⁵⁰⁸ Implementing Regulation, Art 100(2).

⁵⁰⁹ AIFMD, Art 21(12), second paragraph. In a similar vein, see also Art 24(1), second paragraph, second sentence of the European Commission's proposal for UCITS V (n 385).

⁵¹⁰ AIFMD, recital (44).

⁵¹¹ Implementing Regulation, Art 101(1)(a).

⁵¹² Implementing Regulation, Art 101(1)(b).

(c) Despite rigorous and comprehensive due diligence, the depositary could not have prevented the loss.⁵¹³

1.451 The requirements under (a) and (b) may be deemed to be fulfilled in the following circumstances: (i) natural events beyond human control or influence; (ii) the adoption of any law, decree, regulation, decision, or order by any government or governmental body, including any court or tribunal which impacts the financial instruments held in custody; (iii) war, riots, or other major upheavals.⁵¹⁴

1.452 The requirements under (a) and (b) are deemed not to be fulfilled in cases such as: (i) an accounting error; (ii) operational failure; (iii) fraud; and (iv) failure to apply the segregation requirements at the level of the depositary or a third party to whom the custody of financial instruments held in custody has been delegated.⁵¹⁵

1.453 These conditions apply *mutatis mutandis* to the delegate when the depositary has contractually transferred its liability in accordance with Article 21(13) and (14) of the AIFMD.

C. Liability for other losses

1.454 The depositary is also liable to the AIF, or to the investors of the AIF, for all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations pursuant to the AIFMD.⁵¹⁶

D. Depositary's liability in case of delegation; discharge of liability

a. General

1.455 The depositary's liability is not affected by any delegation of custody functions. However, in case of a loss of financial instruments held in custody by a third party pursuant to a delegation of the depositary's custody functions, the depositary may discharge itself of liability if it can prove that the following conditions are satisfied.⁵¹⁷

⁵¹³ Implementing Regulation, Art 101(1)(c). This condition may be deemed to be fulfilled when the depositary has ensured that the depositary and the third party to whom the custody of financial instruments held in custody has been delegated have taken all of the following actions: (i) establishing, implementing, applying, and maintaining structures and procedures and insuring expertise adequate and proportionate to the nature and complexity of the assets of the AIF in order to identify in a timely manner and monitor on an ongoing basis external events which may result in a loss of a financial instrument held in custody; (ii) assessing on an ongoing basis whether any of the events identified under (i) presents a significant risk of loss of a financial instrument held in custody; and (iii) informing the AIFM of the significant risks identified and taking appropriate actions, if any, to prevent or mitigate the loss of financial instruments held in custody, where actual or potential external events have been identified which are believed to present a significant risk of loss of a financial instrument held in custody. See Implementing Regulation, Art 101(1)(c)(i)–(iii).

⁵¹⁴ Implementing Regulation, Art 101(2).

⁵¹⁵ Implementing Regulation, Art 103(1)(e).

⁵¹⁶ AIFMD, Art 21(12), third paragraph. In a similar vein, see Art 24(1), third paragraph of the European Commission's proposal for UCITS V (n 385).

⁵¹⁷ AIFMD, Art 21(13), first paragraph. See, similarly, UCITS Directive (n 2), Art 32(2). However, such discharge of liability is not available under the UCITS Directive (n 2). In a similar vein, see also Art 24(2) of the European Commission's proposal for UCITS V (n 385), again with no possibility of discharge of liability. In the European Commission's proposal for UCITS V (n 385) this is explained as follows: "This strengthening of the liability in case of delegation of custody appears justified in light of the very large investors base and the retail nature of UCITS holders. Introducing a regime with the same contractual possibility for the depositary to be discharged of its liability as it is allowed under AIFM Directive, is not considered to be entirely appropriate. To a similar extent, envisaging that the liability of the depositary could be discharged where assets are transferred to a sub-custodian that does not comply with delegation criteria would also not be appropriate" (pp 8–9).

b. Delegation requirements

All requirements for the delegation of its custody tasks have been met (see paragraphs 1.436 to 1.440).⁵¹⁸ **1.456**

c. Transfer of liability

A written contract between the depositary and the third party expressly transfers the liability of the depositary to that third party and makes it possible for the AIF or the AIFM acting on behalf of the AIF to make a claim against the third party in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf.⁵¹⁹ **1.457**

In other words, the AIFMD intends such contract to have external effects, making the third party liable to the AIF or to the investors of the AIF for the loss of the financial instruments held in custody.⁵²⁰ **1.458**

d. Objective reasons for discharge of liability

A written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF expressly allows a discharge of the depositary's liability and establishes the objective reason to contract such a discharge.⁵²¹ **1.459**

The objective reasons for contracting a discharge must be (i) limited to precise and concrete circumstances characterizing a given activity and (ii) consistent with the depositary's policies and decisions.⁵²² The objective reasons must be established each time the depositary intends to discharge itself of liability.⁵²³ **1.460**

The depositary is deemed to have objective reasons for contracting the discharge of its liability when it can demonstrate that it had no other option but to delegate its custody duties to a third party. In particular, this is the case when: (i) the law of a third country requires that certain financial instruments be held in custody by a local entity and local entities exist that satisfy the delegation criteria laid down in the AIFMD; or (ii) the AIFM insists on maintaining an investment in a particular jurisdiction despite warnings by the depositary as to the increased risk this presents.⁵²⁴ **1.461**

E. Depositary's liability in case of delegation to a local entity in a third country

Where the law of a third country requires that certain financial instruments are held in custody by a local entity and there are no local entities that satisfy the delegation requirements, the depositary can discharge itself of liability provided that the following conditions are met: **1.462**

- (a) the rules or instruments of incorporation of the AIF concerned expressly allow for such a discharge under the conditions set out in this paragraph;

⁵¹⁸ AIFMD, Art 21(13)(a).

⁵¹⁹ AIFMD, Art 21(13)(b).

⁵²⁰ AIFMD, recital (45). In many jurisdictions the express consent of the creditor is required for a transfer of liability. Cf. Wymeersch, 'The European Alternative Investment Fund Management Directive' (n 64) 467. It is not clear whether such consent requirement is still permitted in this context. In any event, for investors a discharge would mean an additional burden in that they may have to sue in several jurisdictions, under different legal regimes. See Wymeersch, 'The European Alternative Investment Fund Management Directive' (n 64) 467.

⁵²¹ AIFMD, Art 21(13)(c).

⁵²² Implementing Regulation, Art 102(1).

⁵²³ Implementing Regulation, Art 102(2).

⁵²⁴ Implementing Regulation, Art 102(3).

- (b) the investors of the relevant AIF have been duly informed of that discharge and of the circumstances justifying the discharge prior to their investment;
- (c) the AIF or the AIFM on behalf of the AIF instructed the depositary to delegate the custody of such financial instruments to a local entity;
- (d) there is a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF, which expressly allows such a discharge; and
- (e) there is a written contract between the depositary and the third party that expressly transfers the liability of the depositary to the local entity and makes it possible for the AIF or the AIFM acting on behalf of the AIF to make a claim against that local entity in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf.⁵²⁵

F. How liability can be invoked

1.463 Liability to the investors of the AIF may be invoked directly or indirectly through the AIFM, depending on the legal nature of the relationship between the depositary, the AIFM, and the investors.⁵²⁶

15. Duty of information towards competent authorities; sharing of information between competent authorities

1.464 On request, the depositary must make available to its competent authorities all information which it has obtained while performing its duties, and which may be necessary for the competent authorities of the AIF or AIFM.⁵²⁷ If the competent authorities of the AIF or AIFM are different from those of the depositary, the competent authorities of the depositary must share the information received without delay with the competent authorities of the AIF and AIFM.⁵²⁸

VII. Transparency Requirements

1. General

1.465 One of the main objectives of the AIFMD is to increase the transparency of AIFMs vis-à-vis investors and competent authorities. The financial crisis has highlighted the range of risks to which investors in investment funds are exposed. The AIFMD seeks to introduce safeguards to ensure that investors in AIFs are well informed and adequately protected.

1.466 To that end, the AIFMD provides minimum requirements regarding the annual report of the AIF, disclosure to investors before they invest into the AIF as well as on a periodic basis thereafter, and reporting to competent authorities.⁵²⁹ These requirements are set out in the following section.

⁵²⁵ AIFMD, Art 21(14) and recital (46).

⁵²⁶ AIFMD, Art 21(15). In a similar vein, see Art 24(5) of the European Commission's proposal for UCITS V (n 385).

⁵²⁷ AIFMD, Art 21(16), first sentence. Similarly, see UCITS Directive (n 2), Art 33(4). See also Art 26(a) of the European Commission's proposal for UCITS V (n 385).

⁵²⁸ AIFMD, Art 21(16), second sentence.

⁵²⁹ ESMA Advice (n 213) 217. Cf. FSA, DP 12/1 (n 213) 55, paras 6.1, 6.2. See also on the transparency requirements, D.A. Zetzsche, 'Investor Information, Disclosure and Transparency' in Zetzsche, *The Alternative Investment Fund Managers Directive* (n 21) 333 et seq.

2. Annual report (Article 22)

A. General

The annual reporting provisions aim to ensure that investors and regulators remain properly informed about the financial and business affairs and the risk profiles of AIFs under management. The AIFMD does not specify much detail in the annual reporting requirements, but 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.⁵³⁰ **1.467**

All information provided in the annual report must be presented in a manner that provides materially relevant, reliable, comparable, and clear information. The annual report must contain the information investors need in relation to particular AIF structures.⁵³¹ **1.468**

An AIFM must, for each of (i) the EU AIFs it manages and (ii) the AIFs it markets in the Union, make available an annual report for every financial year no later than six months following the end of the financial year.⁵³² The six-month period is without prejudice to the right of the Member States to impose a shorter period.⁵³³ **1.469**

The annual report must (i) be provided to investors on request,⁵³⁴ (ii) be made available to the competent authorities of the home Member State of the AIFM, and, where applicable, (iii) be made available to the home Member State of the AIF.⁵³⁵ **1.470**

Where the AIF is required to make public an annual financial report in accordance with the Transparency Directive, only such additional information set out in paragraph 1.472 needs to be provided to investors on request, either separately or as an additional part of the annual financial report. In the latter case the annual financial report must be made public no later than four months following the end of the financial year.⁵³⁶ **1.471**

B. Content of the annual report

The annual report for each AIF managed or marketed in the EU must at least (ie minimum harmonization) contain the following information: **1.472**

- (a) a balance sheet or statement of assets and liabilities;⁵³⁷
- (b) an income and expenditure account for the financial year;⁵³⁸
- (c) a report on the activities of the financial year;⁵³⁹

⁵³⁰ FSA DP 12/1 (n 213) 59, para 6.29.

⁵³¹ Implementing Regulation, Art 103.

⁵³² AIFMD, Art 22(1), first paragraph, first sentence. In the case of UCITS investment companies the term is four months following the end of the financial year (UCITS Directive (n 2), Art 68(2)(a)).

⁵³³ AIFMD, recital (48).

⁵³⁴ In the case of a UCITS the annual report must also be provided to investors on request, but always free of charge (UCITS Directive (n 2), Art 75(1)).

⁵³⁵ AIFMD, Art 22(1), first paragraph, second and third sentences.

⁵³⁶ AIFMD, Art 22(1), second paragraph.

⁵³⁷ AIFMD, Art 22(2)(a), further specified in Implementing Regulation, Art 104(1), (3), (4), (5), (6). See, for a similar provision, UCITS Directive (n 2), Art 69(3), further specified (but in less detail as in the AIFMD regime) in Annex I, Sch B, point 1 (statement of assets and liabilities).

⁵³⁸ AIFMD, Art 22(2)(b), further specified in Implementing Regulation, Art 104(2), (7), and Annex IV. See, for a similar provision, UCITS Directive (n 2), Art 69(3) (but, unlike the AIFMD regime, without any further specification).

⁵³⁹ AIFMD, Art 22(2)(c). See, for a similar provision, UCITS Directive (n 2), Art 69(3). Article 22(2)(c) is further specified in Implementing Regulation, Art 105.

- (d) any material changes in the information listed in Article 23 of the AIFMD (disclosure to investors: see paragraphs 1.476 to 1.481) during the financial year covered by the report;⁵⁴⁰
- (e) the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, the number of beneficiaries, and, where relevant, carried interest paid by the AIF;⁵⁴¹
- (f) 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.⁵⁴²

C. Applicable accounting standards

- 1.473** The accounting information given in the annual report must be prepared in accordance with (i) the accounting standards of the home Member State of the AIF or (ii) in accordance with the accounting standards of the third country where the AIF is established and in accordance with the accounting rules laid down in the AIF rules or instruments of incorporation.⁵⁴³

D. Auditing

- 1.474** The accounting information given in the annual report must be audited by one or more persons empowered by law to audit accounts in accordance with Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts.⁵⁴⁴ The auditor's report, including any qualifications, must be reproduced in full in the annual report.⁵⁴⁵
- 1.475** By way of derogation from the foregoing, Member States may permit AIFMs marketing non-EU AIFs to subject the annual reports of those AIFs to an audit meeting international auditing standards in force in the country where the AIF has its registered office.⁵⁴⁶

3. Disclosure to investors (Article 23)

A. General

- 1.476** AIFMs are required to make available certain information to investors before they invest in an AIF. Article 23 (disclosure to investors) of the AIFMD does not prescribe any format for this; unlike the UCITS regime, the AIFMD regime does not require the publication of a prospectus in the traditional sense⁵⁴⁷ or a key investor information document (KIID).⁵⁴⁸

⁵⁴⁰ AIFMD, Art 22(2)(d). This requirement is further specified in Implementing Regulation, Art 106. Article 106(1) defines 'material changes' as follows: 'Any changes in information . . . if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including because such information could impact an investor's ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors of the AIF'.

⁵⁴¹ AIFMD, Art 22(2)(e). This requirement is further specified in Implementing Regulation, Art 107.

⁵⁴² AIFMD, Art 22(2)(f).

⁵⁴³ AIFMD, Art 22(3), first paragraph.

⁵⁴⁴ OJ 2006 L157/87.

⁵⁴⁵ AIFMD, Art 22(3), second paragraph.

⁵⁴⁶ AIFMD, Art 22(3).

⁵⁴⁷ See UCITS Directive (n 2), Arts 68(1)(a), 69(1), 70–75, UCITS Directive (n 2), Annex I, Sch A; and Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website (OJ 2010 L176/1) ('UCITS Regulation'), Art 38. See also Wymeersch, 'The European Alternative Investment Fund Management Directive' (n 64) 468.

⁵⁴⁸ UCITS Directive (n 2), Arts 78–82, specified in detail in the UCITS Regulation (n 547).

The overall disclosure requirement will vary according to AIF type and to the extent that it is already subject to other EU disclosure requirements, such as those contained in the Prospectus Directive.⁵⁴⁹ In addition, AIFs authorized in a Member State will be subject to national requirements where these apply. UK-authorized funds (NURSs and QISs) will be subject to any additional FSA rules that apply.⁵⁵⁰ **1.477**

B. Disclosure of information prior to investment and of material changes

AIFMs must (i) for each of the EU AIFs they manage and (ii) for each of the AIFs they market in the Union, make available to AIF investors, in accordance with the AIF rules or instruments of incorporation,⁵⁵¹ the following information before they invest in the AIF, as well as any material changes⁵⁵² thereof:⁵⁵³ **1.478**

- (1) a description of the investment strategy and objectives of the AIF;
- (2) information on where any master AIF is established and where the underlying funds are established if the AIF is a fund of funds;
- (3) a description of the types of assets in which the AIF may invest;
- (4) the techniques it may employ and all associated risks;
- (5) any applicable investment restrictions;
- (6) the circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the associated risks, any restrictions on the use of leverage, any collateral and asset re-use arrangements, and the maximum level of leverage which the AIFM are entitled to employ on behalf of the AIF;⁵⁵⁴
- (7) a description of the procedures by which the AIF may change its investment strategy or investment policy, or both;⁵⁵⁵
- (8) a description of the main legal implication of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, on the applicable law, and on the existence or not of any legal instruments providing for the recognition and enforcement of judgments in the territory where the AIF is established;⁵⁵⁶
- (9) the identity of the AIFM, the AIF's depository, auditor, and any other service providers and a description of their duties and the investors' rights;⁵⁵⁷

⁵⁴⁹ 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 (OJ 2003 L345/64), as amended by Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (OJ 2010 L327/1) ('Prospectus Directive').

⁵⁵⁰ FSA DP 12/1 (n 213) 55, paras 6.3–6.4.

⁵⁵¹ In the case of UCITS the prospectus must always be provided to investors on request and free of charge (UCITS Directive (n 2), Art 75(1)).

⁵⁵² Implementing Regulation, Art 106(1) defines 'material changes' as follows: 'Any changes in information... if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including because such information could impact an investor's ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors of the AIF'.

⁵⁵³ AIFMD, Art 23(1), opening words.

⁵⁵⁴ AIFMD, Art 23(1)(a).

⁵⁵⁵ AIFMD, Art 23(1)(b).

⁵⁵⁶ AIFMD, Art 23(1)(c).

⁵⁵⁷ AIFMD, Art 23(1)(d).

- (10) a description of how the AIFM is complying with the duty to cover potential professional liability risks;⁵⁵⁸
- (11) a description of any delegated management function as referred to in Annex I of the Directive by the AIFM and of any safe-keeping function delegated by the depositary, the identification of the delegate, and any conflicts of interest that may arise from such delegations;⁵⁵⁹
- (12) a description of the AIF's valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets in accordance with Article 19 (valuation; see paragraphs 1.318 to 1.331);⁵⁶⁰
- (13) a description of the AIF's liquidity risk management, including the redemption rights both in normal and in exceptional circumstances, and the existing redemption arrangements with investors;⁵⁶¹
- (14) a description of all fees, charges, and expenses and of the maximum amounts thereof which are directly or indirectly borne by investors;⁵⁶²
- (15) a description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investor who obtain such preferential treatment, and, where relevant, their legal or economic links with the AIF or AIFM;⁵⁶³
- (16) the latest annual report referred to in Article 22 (see paragraphs 1.467 to 1.475);⁵⁶⁴
- (17) the procedure and conditions for the issue and sale of units or shares;⁵⁶⁵
- (18) the latest net asset value of the AIF or the latest market price of the unit or share of the AIF, in accordance with Article 19 (see paragraphs 1.318 to 1.331);⁵⁶⁶
- (19) where available, the historical performance of the AIF;⁵⁶⁷
- (20) the identity of the prime broker and a description of any material arrangements of the AIF with its prime brokers and the way the conflicts of interest in relation thereto are managed and the provision in the contract with the depositary on the possibility of transfer and re-use of AIF assets (ie rehypothecation), and information about any transfer of liability to the prime broker that may exist;⁵⁶⁸
- (21) a description of how and when the information required under Article 23 (4) and (5) (see paragraphs 1.480 to 1.481) will be disclosed.⁵⁶⁹

⁵⁵⁸ AIFMD, Art 23(1)(e).

⁵⁵⁹ AIFMD, Art 23(1)(f).

⁵⁶⁰ AIFMD, Art 23(1)(g).

⁵⁶¹ AIFMD, Art 23(1)(h).

⁵⁶² AIFMD, Art 23(1)(i).

⁵⁶³ AIFMD, Art 23(1)(j). The FSA considers 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. See FSA DP 12/1 (n 213) 57, para 6.13.

⁵⁶⁴ AIFMD, Art 23(1)(k).

⁵⁶⁵ AIFMD, Art 23(1)(l).

⁵⁶⁶ AIFMD, Art 23(1)(m).

⁵⁶⁷ AIFMD, Art 23(1)(n).

⁵⁶⁸ AIFMD, Art 23(i)(o).

⁵⁶⁹ AIFMD, Art 23(1)(p).

- (22) The AIFM must inform the investors, without delay: (i) before they invest in the AIF, of any arrangement made by the depositary to contractually discharge itself of liability in accordance with Article 21(13) (see paragraphs 1.455 to 1.461); (ii) of any changes with respect to depositary liability.⁵⁷⁰

C. Relationship with Prospectus Directive and national prospectus legislation

Where the AIF is required to publish a prospectus in accordance with the Prospectus Directive or in accordance with national law, only such information referred to in Article 23(1) and (2) (see paragraph 1.478) which is in addition to that contained in the prospectus needs to be disclosed separately or as additional information in the prospectus.⁵⁷¹ **1.479**

D. Periodic and regular disclosure of information

AIFMs must, for each of the EU AIFs they manage and for each of the AIFs they market in the Union, periodically disclose to investors: **1.480**

- (a) the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature;⁵⁷²
- (b) any new arrangements for managing the liquidity of the AIF;⁵⁷³
- (c) the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks.⁵⁷⁴

AIFMs that manage EU AIFs employing leverage or that market in the EU AIFs employing leverage must, for each such AIF, disclose, on a regular basis (i) any changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any right of the re-use of collateral or any guarantee granted under the leveraging arrangement⁵⁷⁵ and (ii) the total amount of leverage employed by that AIF.⁵⁷⁶ **1.481**

4. Reporting obligations to competent authorities (Article 24)

A. General

During the events at the end of 2008, regulators and governments globally did not always have all the information they needed to make effective intervention decisions, nor could they get to that information efficiently or expediently.⁵⁷⁷ The AIFMD seeks to plug that gap by imposing substantial reporting obligations on AIFMs, permitting regulators to monitor the market activities of AIFs in a manner similar to the monitoring of other regulated financial institutions. The increased transparency should facilitate the detection and response to risks in the relevant markets, including, in particular, systemic risk.⁵⁷⁸ **1.482**

⁵⁷⁰ AIFMD, Art 23(2).

⁵⁷¹ AIFMD, Art 23(3).

⁵⁷² AIFMD, Art 23(4)(a). This requirement is further specified in Implementing Regulation, Art 108(1), (2).

⁵⁷³ AIFMD, Art 23(4)(b). This requirement is further specified in Implementing Regulation, Art 108(1), (3).

⁵⁷⁴ AIFMD, Art 23(4)(c). These requirements are further specified in Implementing Regulation, Art 108(4), (5).

⁵⁷⁵ AIFMD, Art 23(5)(a). These requirements are further specified in Implementing Regulation, Art 109(1), (2).

⁵⁷⁶ AIFMD, Art 23(5)(b). This requirement is further specified in Implementing Regulation, Art 109(1), (3).

⁵⁷⁷ See, eg Commission Staff Document SWD (2012) 386 final, 'Impact Assessment', 12 (accompanying the draft Implementing Regulation).

⁵⁷⁸ ESMA Advice (n 213) 217; FSA DP 12/1 (n 213) 61, para 6.37.

B. General reporting and disclosure obligations

- 1.483** An AIFM must inform its national regulator⁵⁷⁹ regularly about its trading activities.⁵⁸⁰ The reports⁵⁸¹ must include information about the instruments the AIFM is trading,⁵⁸² the markets where it trades,⁵⁸³ and the principal exposures and most important concentrations of each of its AIFs.⁵⁸⁴
- 1.484** An AIFM must, for each of the EU AIFs it manages and the AIFs it markets in the Union, provide the following information⁵⁸⁵ to its national regulator: the percentage of the AIF's assets which are subject to special arrangements, ie side-pockets, arising from their illiquid nature;⁵⁸⁶ any new arrangements for managing the liquidity of the AIF;⁵⁸⁷ the current risk profile of the AIF⁵⁸⁸ and the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk, and other risks including operational risk;⁵⁸⁹ information on the main categories of assets in which the AIF invested;⁵⁹⁰ and the results of the stress tests performed in normal and exceptional circumstances, in accordance with Article 15(3)(b) and Article 16(1), second paragraph of the AIFMD.⁵⁹¹
- 1.485** The AIFM must, on request, provide to its national regulator an annual report of each EU AIF managed and of each AIF marketed by the AIFM in the Union for each financial year, in accordance with Article 22(1)⁵⁹² and, for the end of each quarter, a detailed list of all AIFs managed by the AIFM.⁵⁹³
- 1.486** An AIFM that manages AIFs employing leverage on a substantial basis⁵⁹⁴ must inform its national regulator about: the overall level of leverage employed by each AIF it manages; a breakdown of leverage arising from borrowing of cash or securities and leverage embedded

⁵⁷⁹ In accordance with AIFMD, Art 42(1)(a), for non-EU AIFMs any references to the competent authorities of the home Member States means the competent authority of the Member State of reference, ie where the AIF is marketed (Implementing Regulation, Art 110(7)).

⁵⁸⁰ AIFMD, Art 24(1), first paragraph. The paragraph also refers to markets 'of which it is a member' but it seems highly unlikely that the manager/operator of a collective investment scheme will also conduct, or be permitted to conduct, brokerage activities, ie the investment service within the meaning of MiFID (n 14).

⁵⁸¹ See, for the terms within which this information referred to in AIFMD, Art 24(1), second subparagraph must be provided, Implementing Regulation, Art 110(1), *in fine*, (3), (4). The information must be provided in accordance with the pro-forma reporting template as set out in the Annex (Implementing Regulation, Art 110(6)).

⁵⁸² AIFMD, Art 24(1), second paragraph, further specified in Implementing Regulation, Art 110(1)(a).

⁵⁸³ AIFMD, Art 24(1), second paragraph and Implementing Regulation, Art 110(1)(b).

⁵⁸⁴ AIFMD, Art 24(1), second paragraph. Note that Implementing Regulation, Art 112(1)(c) provides a broader formulation of this requirement by referring to 'the diversification of the AIF's portfolio including, but not limited to, its principal exposures and most important concentrations'.

⁵⁸⁵ For the terms within which this information referred to in AIFMD, Art 24(2) AIFMD must be provided, see Implementing Regulation, Art 110(3), (4). The information must be provided in accordance with the pro-forma reporting template as set out in the Annex (Implementing Regulation, Art 110(6)).

⁵⁸⁶ AIFMD, Art 24(2)(a) and Implementing Regulation, Art 110(2)(a).

⁵⁸⁷ AIFMD, Art 24(2)(b) and Implementing Regulation, Art 110(2)(b).

⁵⁸⁸ AIFMD, Art 24(2)(c), first part, further specified in Implementing Regulation, Art 110(2)(d).

⁵⁸⁹ AIFMD, Art 24(2)(c), second part and Implementing Regulation, Art 110(2)(c).

⁵⁹⁰ AIFMD, Art 24(2)(d), further specified in Implementing Regulation, Art 110(2)(e).

⁵⁹¹ AIFMD, Art 24(2)(e) and Implementing Regulation, Art 110(2)(f). See paras 1.469–1.471.

⁵⁹² AIFMD, Art 24(3)(a). See paras 1.469–1.471.

⁵⁹³ AIFMD, Art 24(3)(b).

⁵⁹⁴ Leverage is considered to be employed on a substantial basis when the exposure of an AIF as calculated according to the commitment method under Implementing Regulation, Art 8 exceeds three times its net asset value (Implementing Regulation, Art 111(1)).

in financial derivatives; and the extent to which the AIF's assets have been re-used under leveraging arrangements.⁵⁹⁵

The information listed in paragraph 1.486 must include the identity of the five largest sources of borrowed cash or securities for each of the AIFs managed by the AIFM, and the amounts of leverage received from each of those sources for each of those AIFs.⁵⁹⁶ **1.487**

For non-EU AIFMs, the reporting obligations on leverage are limited to EU AIFs managed and non-EU AIFs marketed by them in the Union.⁵⁹⁷ **1.488**

C. Additional disclosure requirements

Where necessary for the effective monitoring of systemic risk, an AIFM's national regulator may periodically, or ad hoc, require additional information. The national regulators must inform ESMA about the additional information requirements.⁵⁹⁸ **1.489**

In exceptional circumstances and where required in order to ensure the stability and integrity of the financial system or to promote long-term sustainable growth, ESMA may request the national regulators to impose additional reporting requirements.⁵⁹⁹ **1.490**

VIII. AIFM Managing Specific Types of AIF

1. Leveraged AIFs (Article 25)

A. Use and sharing of information about leverage by regulators

The Member States are responsible for ensuring that the national regulators use the information gathered pursuant to Article 24 of the AIFMD to identify and monitor the build-up of systemic risk in the financial system, any risk of disorderly markets, or any risks to the long-term growth of the economy.⁶⁰⁰ **1.491**

The national regulators must share the relevant information with each other and with ESMA and the ESRB in accordance with the supervisory cooperation procedures set out in Article 50 of the AIFMD. Information must also be shared where an AIF or AIFM becomes an important source of potential counterparty risk to a credit institution or other systemically relevant institution in another Member State.⁶⁰¹ **1.492**

B. Action by national regulators

If the national regulator deems it necessary to preserve the stability and integrity of the financial system, it may impose leverage limits or other restrictions on an AIFM in relation to one or more of its AIFs with a view to limiting the build-up of systemic risk in the financial system or mitigating the risks of disorderly markets. **1.493**

⁵⁹⁵ AIFMD, Art 24(4), first paragraph and Implementing Regulation, Art 111(2).

⁵⁹⁶ AIFMD, Art 24(4), second paragraph and Implementing Regulation, Art 111(2).

⁵⁹⁷ AIFMD, Art 24(4), third paragraph and Implementing Regulation, Art 111(2).

⁵⁹⁸ AIFMD, Art 24(5), first paragraph.

⁵⁹⁹ AIFMD, Art 24(5), second paragraph.

⁶⁰⁰ AIFMD, Art 25(1) and Implementing Regulation, Art 112 which sets out certain matters regulators must take into account when assessing systemic risk.

⁶⁰¹ AIFMD, Art 25(2).

- 1.494** The national regulator must notify ESMA, the ESRB, and the national regulator of any affected AIF before imposing leverage limits and inform the same about any actions taken, all in accordance with the cooperation procedures of Article 50 AIFMD.⁶⁰² The notification is subject to a notice period of 10 business days. In exceptional circumstances, the national regulator may decide to ignore the notice period.⁶⁰³
- 1.495** ESMA is responsible for facilitating and coordinating the national regulators' actions, and in particular to ensure that a consistent approach is taken across the EU. Upon receipt of a notification, ESMA must advise the national regulator on the proposed action. The advice may, in particular, address whether the conditions for taking action appear to be met, whether the actions are appropriate, and what the effective time period should be.⁶⁰⁴

C. Action by ESMA

- 1.496** ESMA may also intervene if it determines that the leverage employed by an AIFM, or by a group of AIFMs, poses a substantial risk to the stability and integrity of the financial system. In such circumstances, ESMA may advise national regulators to take action, including to limit leverage levels. Before doing so, it must first take advice from the ESRB. ESMA must immediately inform the national regulators concerned, the ESRB, and the Commission if it intends to intervene.⁶⁰⁵
- 1.497** If a national regulator chooses not to follow ESMA's advice it must inform ESMA, giving reasons. ESMA may make the fact that a national regulator intends not to follow its advice public. This may include the given reasons. ESMA must give advance notice before publication.⁶⁰⁶

2. AIFMs managing AIF which acquire a (non-)controlling participation in (non-)listed companies (Articles 26–30)

A. General

- 1.498** By Articles 27 and 28 of the AIFMD, special notification and disclosure requirements apply to AIFMs managing AIFs which acquire a (non-)controlling participation in (non-)listed companies. In addition, specific provisions regarding the annual report of AIFs apply in such cases (Article 29), as well as provisions on 'asset stripping' (Article 30).⁶⁰⁷
- 1.499** The logic for including these rules in the AIFMD is questionable, as they concern the conduct of anyone, not just investment funds, who acquires a (non-)controlling stake in a (non-)listed company. Recital (55) of the AIFMD confirms this: '[t]he Commission is invited to examine the need and the possibilities to amend the information and disclosure requirements applicable in cases of control over non-listed companies and issuers set out in [the

⁶⁰² AIFMD, Art 25(3).

⁶⁰³ AIFMD, Art 25(4).

⁶⁰⁴ AIFMD, Art 25(5), (6).

⁶⁰⁵ Art 25(7).

⁶⁰⁶ AIFMD, Art 25(8).

⁶⁰⁷ In case of control over *listed* companies, the rules of Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids (OJ 2004 L142/12) and the Transparency Directive (n 157) also apply. Cf. AIFMD, recital (53).

AIFMD] on a general level, regardless of the type of investor'. Apparently, this invitation does not extend to the provisions on 'asset stripping'.

B. Scope

Articles 26–30 of the AIFMD apply to (a) AIFMs managing one or more AIFs which either individually or jointly, acting in concert, acquire control over a non-listed company, and (b) AIFMs cooperating with one or more other AIFMs on the basis of an agreement pursuant to which the AIFs, managed by those AIFMs jointly, acquire control over a non-listed company.⁶⁰⁸ **1.500**

However, Articles 26–30 do *not* apply if the non-listed companies are (a) small and medium-sized enterprises within the meaning of Article 2(1) of the Annex to Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises,⁶⁰⁹ or (b) special purpose vehicles with the purpose of purchasing, holding, or administering real estate.⁶¹⁰ **1.501**

Article 27(1) (notification of major holding and control of non-listed companies) also applies to AIFMs managing AIFs that acquire a *non*-controlling participation in a non-listed company.⁶¹¹ **1.502**

Article 28(1)–(3) (disclosure in case of acquisition of control) and Article 30 (asset stripping) also apply to AIFMs managing AIFs that acquire control over *listed* companies ('issuers'⁶¹²). For the purposes of those provisions, Article 26(1) and (2) (see paragraphs 1.500 and 1.501) apply *mutatis mutandis*.⁶¹³ **1.503**

'Control' entails acquisition of more than 50% of the voting rights.⁶¹⁴ When calculating the percentage, the voting rights held by the following persons must be added to the voting rights that are held directly by the AIF: (a) an undertaking controlled by the AIF; and (b) a natural or legal person acting in its own name but on behalf of the AIF or on behalf of an undertaking controlled by the AIF.⁶¹⁵ The calculation must include all shares to which voting rights attach, even if exercise of the rights is suspended.⁶¹⁶ **1.504**

The percentage of voting rights that confers 'control' of *listed* companies ('issuers'⁶¹⁷) for the purposes of Article 28(1)–(3) (disclosure in case of acquisition of control) and Article 30 **1.505**

⁶⁰⁸ AIFMD, Art 26(1).

⁶⁰⁹ AIFMD, Art 26(2)(a). According to Art 2(1) of the Annex to Commission Recommendation 2003/361/EC of 6 May 2003, '[t]he category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million'.

⁶¹⁰ AIFMD, Art 26(2)(b).

⁶¹¹ AIFMD, Art 26(3).

⁶¹² See the definition of 'issuer' in AIFMD, Art 4(1)(t): 'an issuer within the meaning of point (d) of Article 2(1) of Directive 2004/109/EC where that issuer has its registered office in the Union, and where its shares are admitted to trading on a regulated market within the meaning of point (14) of Article 4(1) of Directive 2004/39/EC'.

⁶¹³ AIFMD, Art 26(4).

⁶¹⁴ AIFMD, Art 26(5), first paragraph.

⁶¹⁵ AIFMD, Art 26(5), second paragraph.

⁶¹⁶ AIFMD, Art 26(5), third paragraph.

⁶¹⁷ See the definition of 'issuer' in AIFMD, Art 4(1)(t): 'an issuer within the meaning of point (d) of Article 2(1) of Directive 2004/109/EC where that issuer has its registered office in the Union, and where its shares are admitted to trading on a regulated market within the meaning of point (14) of Article 4(1) of Directive 2004/39/EC'.

(asset stripping) of the AIFMD, as well as the method of calculation, is determined by the rules of the Member State in which the listed company has its registered office.⁶¹⁸

- 1.506** Articles 26–30 AIFMD apply subject to the conditions and restrictions set out in Article 6 (confidential information) of Directive 2002/14/EC on a general framework for informing and consulting employees in the European Community.⁶¹⁹ ⁶²⁰ According to recital (58) of the AIFMD:

[t]his means that Member States should provide that within the limits and conditions laid down by national law the employees' representatives, and anyone assisting them, are not authorised to reveal to employees and to third parties any information affecting the legitimate interests of the company that has expressly been provided to them in confidence. Member States should, however, be able to authorise the employees' representatives and anyone assisting them to pass on confidential information to employees and to third parties bound by an obligation of confidentiality. Member States should provide that the relevant AIFMs do not request the communication of information by the board of directors to the employees' representatives or, where there are none, the employees themselves, when the nature of that information is such that, according to objective criteria, it would seriously harm the functioning of the company concerned or would be prejudicial to it.

- 1.507** Articles 26–30 provide for minimum harmonization. This means that Member States may adopt stricter rules regarding the acquisition of holdings in listed companies ('issuers'⁶²¹) and non-listed companies in their territories.⁶²²

C. Notification of the acquisition of major holdings and control of non-listed companies

- 1.508** When an AIF acquires, disposes of, or holds shares of a non-listed company, the AIFM managing such an AIF must notify its national regulator of the proportion of voting rights of the non-listed company held by the AIF any time when that proportion reaches, exceeds, or falls below the thresholds of 10%, 20%, 30%, 50%, and 75%.⁶²³

- 1.509** When an AIF acquires, individually or jointly, control over a non-listed company, the AIFM must notify the acquisition of control by its AIF to:

- (a) the non-listed company;
- (b) the shareholders of which the identities and addresses are available to the AIFM or can be made available by the non-listed company or through a register to which the AIFM has or can obtain access; and
- (c) its national regulator.⁶²⁴

⁶¹⁸ AIFMD, Art 26(5), fourth paragraph, read in conjunction with Art 5(3) of the Takeover Directive.

⁶¹⁹ Directive 2002/14/EC of the European Parliament and of the Council of 11 March 2002 establishing a general framework for informing and consulting employees in the European Community (OJ 2002 L80/29).

⁶²⁰ AIFMD, Art 26(6).

⁶²¹ See the definition of 'issuer' in AIFMD, Art 4(1)(t): 'an issuer within the meaning of point (d) of Article 2(1) of Directive 2004/109/EC where that issuer has its registered office in the Union, and where its shares are admitted to trading on a regulated market within the meaning of point (14) of Article 4(1) of Directive 2004/39/EC'.

⁶²² AIFMD, Art 26(7). See also recital (58).

⁶²³ AIFMD, Art 27(1).

⁶²⁴ AIFMD, Art 27(2).

The notifications referred to in paragraph 1.509 must include the following additional information: **1.510**

- (a) the resulting situation in terms of voting rights;
- (b) the conditions subject to which control was acquired, including information about the identity of the different shareholders involved, any natural person or legal entity entitled to exercise voting rights on their behalf, and, if applicable, the chain of undertakings through which voting rights are effectively held;
- (c) the date on which control was acquired.⁶²⁵

The notification to the non-listed company must include a request to the board of directors of the company to inform the employees' representatives or, where there are none, the employees themselves, without undue delay, of the acquisition of control by the AIF managed by the AIFM and of the information referred to in paragraph 1.510. The AIFM must use its best efforts to ensure that the employees' representatives or, where there are none, the employees themselves, are duly informed by the board of directors.⁶²⁶ **1.511**

The notifications referred to in paragraphs 1.508 and 1.509 must be made as soon as possible, but no later than 10 working days after the date on which the AIF has reached, exceeded, or fallen below the relevant threshold or has acquired control over the non-listed company.⁶²⁷ **1.512**

D. Disclosure in case of acquisition of control

When an AIF acquires, individually or jointly, control of a non-listed company or a *listed* company (an 'issuer'⁶²⁸), the AIFM managing such AIF must make the information referred to in paragraph 1.515, available to: **1.513**

- (a) the company concerned;
- (b) the shareholders of the company of which the identities and addresses are available to the AIFM or can be made available by the company or through a register to which the AIFM has or can obtain access; and
- (c) its national regulator.⁶²⁹

Member States may require that the information referred to in paragraph 1.515 is also made available to the national regulator of the non-listed company which the Member States may designate to that effect.⁶³⁰ **1.514**

The AIFM must make the following information available: **1.515**

- (a) the identity of the AIFMs which either individually or in agreement with other AIFMs manage the AIFs that have acquired control;
- (b) the policy for preventing and managing conflicts of interest, in particular between the AIFM, the AIF, and the company, including information about the specific safeguards

⁶²⁵ AIFMD, Art 27(3).

⁶²⁶ AIFMD, Art 27(4).

⁶²⁷ AIFMD, Art 27(5).

⁶²⁸ See the definition of 'issuer' in AIFMD, Art 4(1)(t): 'an issuer within the meaning of point (d) of Article 2(1) of Directive 2004/109/EC where that issuer has its registered office in the Union, and where its shares are admitted to trading on a regulated market within the meaning of point (14) of Article 4(1) of Directive 2004/39/EC'.

⁶²⁹ AIFMD, Art 28(1), first paragraph.

⁶³⁰ AIFMD, Art 28(1), second paragraph.

established to ensure that any agreement between the AIFM and/or the AIF and the company is concluded at arm's length; and

- (c) the policy for external and internal communication relating to the company, in particular as regards employees.⁶³¹

1.516 In its notification to the company referred to in paragraph 1.513(a), the AIFM must request the board of directors of the company to inform the employees' representatives or, where there are none, the employees themselves, without undue delay, of the information referred to in paragraph 1.515. The AIFM must use its best efforts to ensure that the employees' representatives or, where there are none, the employees themselves, are duly informed by the board of directors.⁶³²

1.517 In addition, when an AIF acquires, individually or jointly, control of a non-listed company, the AIFM managing such AIF must ensure that the AIF, or the AIFM acting on behalf of the AIF, discloses its intentions with regard to the future business of the non-listed company and the likely repercussions on employment, including any material change in the conditions of employment, to:

- (a) the non-listed company; and
- (b) the shareholders of the non-listed company of which the identities and addresses are available to the AIFM or can be made available by the non-listed company or through a register to which the AIFM has or can obtain access.⁶³³

1.518 Furthermore, the AIFM managing the relevant AIF must request and use its best efforts to ensure that the board of directors of the non-listed company makes available the information referred to in paragraph 1.517 to the employees' representatives or, where there are none, the employees themselves, of the non-listed company.⁶³⁴

1.519 Finally, when an AIF acquires control of a non-listed company, the AIFM managing such an AIF must provide its national regulator and the AIF's investors with information on the financing of the acquisition.⁶³⁵ Although this is not clear from the text of the AIFMD itself, recital (56) states that the obligation to provide information on financing should also apply when an AIFM manages AIFs which acquire control over *listed* companies (an 'issuer'⁶³⁶).

E. Specific provisions regarding the annual report of AIFs exercising control of non-listed companies

1.520 When an AIF acquires, individually or jointly, control of a non-listed company, the AIFM managing such an AIF must either:

- (a) request and use its best efforts to ensure that the annual report of the non-listed company drawn up in accordance with paragraph 1.521 is made available by the board of

⁶³¹ AIFMD, Art 28(2).

⁶³² AIFMD, Art 28(3).

⁶³³ AIFMD, Art 28(4), first paragraph.

⁶³⁴ AIFMD, Art 28(4), second paragraph.

⁶³⁵ AIFMD, Art 28(5).

⁶³⁶ See definition of 'issuer' set out in AIFMD, Art 4(1)(t): 'an issuer within the meaning of point (d) of Article 2(1) of Directive 2004/109/EC where that issuer has its registered office in the Union, and where its shares are admitted to trading on a regulated market within the meaning of point (14) of Article 4(1) of Directive 2004/39/EC'.

directors of the company to the employees' representatives or, where there are none, to the employees themselves within the period such annual report has to be drawn up in accordance with national applicable law; or

- (b) for each such AIF include in the annual report provided for in Article 22 (see paragraphs 1.467 to 1.475) the information referred to in paragraph 1.521 relating to the relevant non-listed company.⁶³⁷

The additional information to be included in the annual report of the company or the AIF must include at least a fair review of the development of the company's business representing the situation at the end of the period covered by the annual report. The report must also give an indication of: **1.521**

- (a) any important events that have occurred since the end of the financial year;
(b) the company's likely future development; and
(c) the information concerning acquisitions of own shares set out in Article 22(2) of Council Directive 77/91/EEC.⁶³⁸

The AIFM managing the relevant AIF must either: **1.522**

- (a) request and use its best efforts to ensure that the board of directors of the non-listed company makes available the information referred to in paragraph 1.520(b) relating to the company concerned to the employees' representatives of the company concerned or, where there are none, to the employees themselves, within the period referred to in Article 22(1) (see paragraph 1.469); or
(b) make available the information referred to in paragraph 1.520(a) to the investors of the AIF, in so far as already available, within the period referred to in Article 22(1) (see paragraph 1.469) and, in any event, no later than the date on which the annual report of the non-listed company is drawn up in accordance with the national applicable law.⁶³⁹

F. Asset stripping

When an AIF, individually or jointly, acquires control of a non-listed company or a *listed* company (an 'issuer'⁶⁴⁰), the AIFM managing such an AIF must, for a period of 24 months following the acquisition of control of the company by the AIF: **1.523**

- (a) not facilitate, support, or instruct any distribution, capital reduction, share redemption, and/or acquisition of own shares by the company as described in paragraph 1.524;

⁶³⁷ AIFMD, Art 29(1).

⁶³⁸ AIFMD, Art 29(2). Article 22(2) of Council Directive 77/91/EEC (OJ 1977 L26/1) provides the following: 'Where the laws of a Member State permit a company to acquire its own shares, either itself or through a person acting in his own name but on the company's behalf, they shall require the annual report to state at least: (a) the reasons for acquisitions made during the financial year; (b) the number and nominal value or, in the absence of a nominal value, the accountable par of the shares acquired and disposed of during the financial year and the proportion of the subscribed capital which they represent; (c) in the case of acquisition or disposal for a value, the consideration for the shares; (d) the number and nominal value or, in the absence of a nominal value, the accountable par of all the shares acquired and held by the company and the proportion of the subscribed capital which they represent'.

⁶³⁹ AIFMD, Art 29(3).

⁶⁴⁰ See definition of 'issuer' set out in AIFMD, Art 4(1)(t): 'an issuer within the meaning of point (d) of Article 2(1) of Directive 2004/109/EC where that issuer has its registered office in the Union, and where its shares are admitted to trading on a regulated market within the meaning of point (14) of Article 4(1) of Directive 2004/39/EC'.

- (b) in so far as the AIFM is authorized to vote on behalf of the AIF at the meetings of the governing bodies of the company, not vote in favour of a distribution, capital reduction, share redemption, and/or acquisition of own shares by the company as described in paragraph 1.524; and
- (c) in any event use its best efforts to prevent distributions, capital reductions, share redemptions, and/or the acquisition of own shares by the company as described in paragraph 1.524.⁶⁴¹

1.524 The obligations imposed on AIFMs set out in paragraph 1.523 relate to the following:

- (a) any distribution (including, in particular, the payment of dividends and of interest relating to shares⁶⁴²) to shareholders made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes, on the understanding that where the uncalled part of the subscribed capital is not included in the assets shown in the balance sheet, this amount will be deducted from the amount of subscribed capital;
- (b) any distribution (including, in particular, the payment of dividends and of interest relating to shares⁶⁴³) to shareholders the amount of which would exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes;
- (c) to the extent that acquisitions of own shares are permitted, the acquisitions by the company, including shares previously acquired by the company and held by it, and shares acquired by a person acting in his own name but on the company's behalf, that would have the effect of reducing the net assets below the amount mentioned in point (a).⁶⁴⁴

1.525 It remains to be seen how effective the 'asset stripping' rules will be in practice. As such, and always without prejudice to applicable rules of national corporate law, they do not seem to prevent or restrict, inter alia: (i) the sale of the target company's assets, (ii) its assets being used as collateral for loans, and (iii) interest payments on loans provided to the target company.

⁶⁴¹ AIFMD, Art 30(1).

⁶⁴² AIFMD, Art 30(3)(a).

⁶⁴³ AIFMD, Art 30(3)(a).

⁶⁴⁴ AIFMD, Art 30(2). The restriction of Art 30(2)(c) is subject to points (b)–(h) of Art 20(1) of Directive 77/91/EEC: see AIFMD, Art 30(3)(c). Furthermore, according to AIFMD, Art 30(3)(b), the provisions on capital reductions do not apply to reduction in the subscribed capital, the purpose of which is to offset losses incurred or to include sums of money in a non-distributable reserve provided that, following that operation, the amount of such reserve is not more than 10% of the reduced subscribed capital.

IX. Marketing AIFs in the EU

1. Marketing of EU AIFs in the home Member State or the Member State of reference (Articles 31 and 39(2))

A. Scope of the marketing authority

Article 31(1) of the AIFMD provides that an authorized EU AIFM may market units or shares of any EU AIF that it manages to professional investors in its home Member State as soon as certain conditions are met.⁶⁴⁵ It follows that an authorized EU AIFM is not entitled, at least not as a matter of its AIFMD authorization to manage one or more AIFs, to market units or shares of EU AIFs managed by third parties. **1.526**

If the AIFM intends to market a feeder AIF pursuant to Article 31, the master AIF must be an EU AIF which is managed by an authorized EU AIFM.⁶⁴⁶ **1.527**

Without prejudice to the right of a Member State to opt to allow AIFMs to market to retail investors in their territory under Article 43,⁶⁴⁷ Member States must require that AIFs managed and marketed by AIFMs be marketed only to professional investors.⁶⁴⁸ **1.528**

B. Notification procedure

The AIFM must notify its national regulator regarding its intentions.⁶⁴⁹ Pursuant to Annex III of the AIFMD (documentation to be provided in case of intended marketing in the home Member State of the AIFM),⁶⁵⁰ the notification must comprise the following documentation and information: **1.529**

- (a) a notification letter,⁶⁵¹ including a programme of operations identifying the AIFs which the AIFM intends to market and information on where the AIFs are established;
- (b) the AIF rules or instruments of incorporation;
- (c) identification of the depositary of the AIF;
- (d) a description of, or any information on, the AIF available to investors;
- (e) information on where the master AIF is established if the AIF is a feeder AIF;
- (f) any additional information referred to in Article 23(1) (disclosure to investors: see paragraph 1.478) for each AIF the AIFM intends to market;
- (g) where relevant, information on the arrangements established to prevent units or shares of the AIF from being marketed to retail investors, including in the case where the

⁶⁴⁵ AIFMD, Art 31(1), first paragraph.

⁶⁴⁶ AIFMD, Art 31(1), second paragraph. 'Feeder AIF' means an AIF which: (i) invests at least 85% of its assets in units or shares of another AIF (the 'master AIF'); (ii) invests at least 85% of its assets in more than one master AIF where those master AIFs have identical investment strategies; or (iii) otherwise has an exposure of at least 85% of its assets to such a master AIF (AIFMD, Art 4(1)(m)). 'Master AIF' means an AIF in which another AIF invests or has an exposure in accordance with Art 4(1)(m) (AIFMD, Art 4(1)(y)).

⁶⁴⁷ See paras 1.566–1.570.

⁶⁴⁸ AIFMD, Art 31(6) in conjunction with Art 34(1).

⁶⁴⁹ AIFMD, Art 31(2), first paragraph.

⁶⁵⁰ See AIFMD, Art 31(2), second paragraph.

⁶⁵¹ In order to ensure uniform conditions of application of this Article, ESMA may develop draft implementing technical standards to determine the form and content of a model for the notification letter (AIFMD, Art 31(5)(a)). Power is conferred on the Commission to adopt these implementing technical standards in accordance with ESMA Regulation (n 29), Art 15: AIFMD, Art 31(5), second paragraph.

AIFM relies on activities of independent entities to provide investment services in respect of the AIF.

- 1.530** Within 20 working days following receipt of a complete notification file, the competent authorities of the AIFM's home Member State must inform the AIFM whether it may start marketing the AIFs identified in the notification.⁶⁵²
- 1.531** The competent authorities of the AIFM's home Member State may prevent the marketing of the AIF only if the AIFM's management of the AIF does not or will not comply with the AIFMD or the AIFM otherwise does not or will not comply with the AIFMD.⁶⁵³
- 1.532** In the case of a positive decision, the AIFM may start marketing the AIF in its home Member State from the date of the notification by the competent authorities to that effect.⁶⁵⁴
- 1.533** In so far as they are different, the competent authorities of the home Member State of the AIFM must also inform the competent authorities of the AIF that the AIFM may start marketing units or shares of the AIF.⁶⁵⁵

C. Material change

- 1.534** In the event of a material change to any of the particulars in the notification file, the AIFM must give written notice⁶⁵⁶ of that change to the competent authorities of its home Member State at least one month before implementing the change, or immediately after an unplanned change has occurred.⁶⁵⁷
- 1.535** If, pursuant to a planned change, the AIFM's management of the AIF would no longer comply with the AIFMD or the AIFM would otherwise no longer comply with the Directive, the relevant competent authorities must inform the AIFM without undue delay that it is not to implement the change.⁶⁵⁸
- 1.536** If a planned change is implemented notwithstanding the above or if an unplanned change has taken place pursuant to which the AIFM's management of the AIF no longer complies with the AIFMD or the AIFM otherwise no longer complies with the Directive, the competent authorities of the AIFM's home Member State must take all due measures in accordance with Article 46 (powers of competent authorities), including, if necessary, the express prohibition of marketing of the AIF.⁶⁵⁹

D. Marketing of EU AIFs in its Member State of reference by a non-EU AIFM (Article 39(2))

- 1.537** Article 39(1) and (2) of the AIFMD gives a non-EU AIFM rights to market EU AIFs that it manages in its Member State of reference. The conditions and notification procedure set

⁶⁵² AIFMD, Art 31(3), first paragraph, first sentence.

⁶⁵³ AIFMD, Art 31(3), first paragraph, second sentence.

⁶⁵⁴ AIFMD, Art 31(3), first paragraph, third sentence.

⁶⁵⁵ AIFMD, Art 31(3), second paragraph.

⁶⁵⁶ In order to ensure uniform conditions of application of this Article, ESMA may develop draft implementing technical standards to determine the form of the written notice (AIFMD, Art 31(5)(b)). Power is conferred on the Commission to adopt these implementing technical standards in accordance with ESMA Regulation (n 29), Art 15: AIFMD, Art 31(5), second paragraph.

⁶⁵⁷ AIFMD, Art 31(4), first paragraph.

⁶⁵⁸ AIFMD, Art 31(4), second paragraph.

⁶⁵⁹ AIFMD, Art 31(4), third paragraph.

out in Article 39(2) and (3) (marketing in the AIFM's Member State of reference) and the obligations of the AIFM in relation to material changes set out in Article 39(9) are replicas of the procedures and requirements of Article 31.

Article 39 will not come into force before 22 July 2015.⁶⁶⁰ Until that time, non-EU AIFMs must rely on Article 42 to market AIFs in the EU.⁶⁶¹ **1.538**

2. Marketing of EU AIFs in Member States other than the home Member State or Member State of reference (Articles 32 and 39(4))

A. Passporting rights for EU and non-EU AIFMs

Article 32(1) of the AIFMD provides that authorized EU AIFMs may market units or shares of an EU AIF that it manages to professional investors in a Member State other than the home Member State of the AIFM as soon as certain conditions are met.⁶⁶² Similar to marketing rights under Article 31, it follows that an authorized EU AIFM is not entitled to market units or shares of EU AIFs that it does not itself manage. **1.539**

If the EU AIF is a feeder AIF the right to market is subject to the condition that the master AIF is also an EU AIF and is managed by an authorized EU AIFM.⁶⁶³ **1.540**

Article 39(4) gives a non-EU AIFM rights to market EU AIFs that it manages in Member States other than its Member State of reference. With the exception of the feeder condition of Article 32(2), the conditions and notification procedure set out in Article 39(4)–(8) (marketing in Member States other than the AIFM's Member State of reference) and the obligations of the non-EU AIFM in relation to material changes set out in Article 39(9) are replicas of the procedures and requirements of Article 32. **1.541**

Article 39 will not come into force before 22 July 2015.⁶⁶⁴ Until that time, the non-EU AIFMs must rely on Article 42 to market AIFs in the EU.⁶⁶⁵ **1.542**

Without prejudice to the right of a Member State to opt to allow AIFMs to market to retail investors in their territory under Article 43, Member States must require that the AIFs managed and marketed by the AIFM be marketed only to professional investors.⁶⁶⁶ **1.543**

B. Notification procedure

An EU AIFM must notify its national regulator of its intentions 'in a language customary in the sphere of international finance'.⁶⁶⁷ Pursuant to Annex IV to the AIFMD (documentation and **1.544**

⁶⁶⁰ See para 1.10.

⁶⁶¹ See para 1.10.

⁶⁶² AIFMD, Art 32(1), first paragraph.

⁶⁶³ AIFMD, Art 32(1), second paragraph. 'Feeder AIF' means an AIF which (i) invests at least 85% of its assets in units or shares of another AIF (the 'master AIF'); (ii) invests at least 85% of its assets in more than one master AIF where those master AIFs have identical investment strategies; or (iii) otherwise has an exposure of at least 85% of its assets to such a master AIF (AIFMD, Art 4(1)(m)). 'Master AIF' means an AIF in which another AIF invests or has an exposure in accordance with Art 4(1)(m) (AIFMD, Art 4(1)(y)).

⁶⁶⁴ See para 1.10.

⁶⁶⁵ See para 1.10.

⁶⁶⁶ AIFMD, Arts 32(9), 39(11).

⁶⁶⁷ AIFMD, Arts 32(6), 39(8). It is submitted that in any event the English language qualifies as such. See for a similar provision, UCITS Directive (n 2), Art 93(4), which, however, provides that the UCITS home and host Member States may agree that the notification is provided in an official language of both Member States.

information to be provided in the case of intended marketing in Member States other than the home Member State of the AIFM)⁶⁶⁸ the notification must include, in addition to the documentation and information required under Article 31 notifications,⁶⁶⁹ a notification letter,⁶⁷⁰ a list of the Member State(s) in which it intends to market, and information about arrangements⁶⁷¹ made for the marketing of AIFs.⁶⁷²

- 1.545** The national regulator of the AIFM must, no later than 20 working days after the date of receipt of the complete notification file, transmit⁶⁷³ the complete notification file to the competent authorities of the host Member States, but only if the AIFM complies with and will continue to comply with the AIFMD.⁶⁷⁴
- 1.546** The national regulator must enclose a statement to the effect that the AIFM concerned is authorized to manage AIFs with a particular investment strategy. The statement⁶⁷⁵ is provided in a language customary in the sphere of international finance.⁶⁷⁶
- 1.547** Upon transmission of the notification file, the national regulator of the AIFM must, without delay, notify the AIFM about the transmission. The AIFM may start marketing the AIF in the AIFM's host Member State as of the date of that notification.⁶⁷⁷
- 1.548** Member States must ensure that electronic transmission and filing of the relevant documents are accepted by their competent authorities.⁶⁷⁸
- 1.549** In so far as they are different, the national regulator of the AIFM must also inform the national regulator of the AIF that the AIFM may start marketing the units or shares of the AIF in the AIFM's host Member State.⁶⁷⁹

⁶⁶⁸ AIFMD, Art 31(2), second paragraph.

⁶⁶⁹ See paras 1.529–1.533.

⁶⁷⁰ In order to ensure uniform conditions of application of this Article, ESMA may develop draft implementing technical standards to determine the form and content of a model for the notification letter: see AIFMD, Arts 32(8)(a), 39(10)(a). Power is conferred on the Commission to adopt the implementing technical standards in accordance with ESMA Regulation (n 29), Art 15: AIFMD, Arts 32(8), 39(10), second subparagraph.

⁶⁷¹ It follows from AIFMD, Arts 32(5) and 39(7) that these arrangements are to be subject to the laws and supervision of the AIFM's host Member State.

⁶⁷² See, for the somewhat different information to be provided where UCITs are marketed in a Member State other than the home Member State, UCITS Directive (n 2), Art 93(1), second paragraph and (2) and UCITS Regulation (n 547), Arts 1–5.

⁶⁷³ In order to ensure uniform conditions of application of this Article, ESMA may develop draft implementing technical standards to determine the form of the transmission (AIFMD, Art 32(8)(c)). Power is conferred on the Commission to adopt the implementing technical standards in accordance with ESMA Regulation (n 29), Art 15: AIFMD, Arts 32(8), 39(10), second subparagraph.

⁶⁷⁴ AIFMD, Arts 32(3), 39(5). See, for a similar provision, UCITS Directive (n 2), Art 93(3), second and third paragraphs. However, the term for transmission of the notification file is 10 working days (instead of 20 working days) after the date of receipt: see UCITS Directive (n 2), Art 93(3), second paragraph.

⁶⁷⁵ In order to ensure uniform conditions of application of this Article, ESMA may develop draft implementing technical standards to determine the form and content of a model for the statement (AIFMD, Art 32(8)(b)). Power is conferred on the Commission to adopt the implementing technical standards in accordance with ESMA Regulation (n 29), Art 15: AIFMD, Arts 32(8), 39(10).

⁶⁷⁶ AIFMD, Arts 32(3), 39(5), second subparagraph, read in conjunction with Arts 32(6), 39(8), first paragraph. It is submitted that in any event the English language qualifies as such.

⁶⁷⁷ AIFMD, Arts 32(4), 39(6), first paragraph. See, for a similar provision, UCITS Directive (n 2), Art 93(3), third paragraph.

⁶⁷⁸ AIFMD, Arts 32(6), 39(8), second paragraph. See, for a similar provision, UCITS Directive (n 2), Art 93(5).

⁶⁷⁹ AIFMD, Arts 32(4), 39(6), second paragraph.

C. Material change

The same material change provisions that apply in the case of marketing of units or shares of EU AIFs in the AIFM's home Member State apply in the case of marketing such units or shares in Member States other than in the home Member State, including the AIFM's duty to give written notice⁶⁸⁰ of the material change to the competent authorities of its home Member State.⁶⁸¹ **1.550**

If the changes are acceptable because they do not affect the compliance of the AIFM's management of the AIF with the AIFMD, or the compliance by the AIFM with the AIFMD otherwise, the competent authorities of the AIFM's home Member State must, without delay, inform the competent authorities of the host Member State of those changes.⁶⁸² **1.551**

*3. Marketing of non-EU AIFs in the EU (Articles 35 and 40)***A. Passporting rights for EU and non-EU AIFMs**

Articles 35(1) and 40 of the AIFMD permit EU and non-EU AIFMs, respectively, to market non-EU AIFs, including feeder AIFs that invest in non-EU master AIFs, to professional investors in the EU when the conditions of Articles 35 and 40 are met. **1.552**

Articles 35 and 40 will not come into force before 22 July 2015.⁶⁸³ Until these provisions come into force, authorized EU AIFMs must rely on Article 35 to market non-EU AIFs in the EU. Non-EU AIFMs must rely on Article 42.⁶⁸⁴ **1.553**

Under Articles 35(2) and 40(2), the AIFM must comply with all the requirements of the Directive. In addition, the following conditions must be met: **1.554**

- (a) appropriate cooperation arrangements must be in place between the AIFM's national regulator (or, in case of non-EU AIFM, its Member State of reference) and the supervisory authorities of the non-EU AIF to ensure at least an efficient exchange of information, taking into account Article 50(4), so that the AIFM's regulator may carry out its duties under the Directive;
- (b) the non-EU AIF's country is not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force (FATF); and
- (c) the non-EU AIF's country has signed an agreement with the AIFM's home Member State (or, in case of a non-EU AIFM, its Member State of reference) and with each other Member State in which the units or shares of the non-EU AIF are intended to be marketed, which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention on Income and Capital and ensures an effective exchange of information in tax matters, including any multilateral tax agreements.

⁶⁸⁰ In order to ensure uniform conditions of application of this Article, ESMA may develop draft implementing technical standards to determine the form of the written notice (AIFMD, Art 32(8)(d)). Power is conferred on the Commission to adopt the implementing technical standards in accordance with ESMA Regulation (n 29), Art 15: AIFMD: Art 32(8), second subparagraph.

⁶⁸¹ AIFMD, Art 32(7), first to third paragraphs.

⁶⁸² AIFMD, Art 32(7), fourth paragraph. See, for a somewhat different provision with respect to changes, UCITS Directive (n 2), Art 93(7) and (8).

⁶⁸³ See para 1.10.

⁶⁸⁴ See para 1.10.

1.555 Articles 35(2) and 40(2), final paragraph give the competent authority of another Member State the right to petition to ESMA if it disagrees with the assessment made by the AIFM's national regulator (or, in case of a non-EU AIFM, its Member State of reference) regarding the matters listed under (a) and (b) in paragraph 1.554. Article 19 of the ESMA Regulation provides for an arbitration procedure. Where the national regulators cannot reach agreement, ESMA may make a binding decision.⁶⁸⁵

B. Notification procedure and material change

1.556 The notification procedures set out in Articles 35(3) and (4) and 40(3) and (4) of the AIFMD (marketing in the AIFM's home Member State or, in the case of a non-EU AIFM, its Member State of reference) and Articles 35(5)–(9) and 40(5)–(9) (marketing in Member States other than the home Member State or, in the case of a non-EU AIFM, its Member State of reference), and the obligations of the AIFM in relation to material changes set out in Articles 35(10) and 40(10) are replicas of the procedures and requirements of Article 31 and 32.

4. Marketing of non-EU AIFs in the EU subject to national regimes by EU and non-EU AIFMs (Articles 36 and 42)

A. Marketing of non-EU AIFs pursuant to national regimes by an authorized EU AIFM (Article 36)

1.557 Article 36(1) of the AIFMD permits Member States, without prejudice to Article 35, to allow an authorized EU AIFM to market to professional investors—in their territory only—units or shares of non-EU AIFs it manages and of EU feeder AIFs that do not invest in EU master AIFs subject to the conditions of Article 36. These are minimum requirements. Article 36(2) permits Member States to impose stricter rules on the AIFM. Indeed, some Member States may not permit marketing under Article 36 at all.

1.558 Under Article 36(1)(a), a non-EU AIFM must comply with the AIFMD with the exception of Article 21 (depository requirements), provided that an independent party is appointed to perform the functions set out in Article 21(7) (monitoring of cash flows), 21(8) (assets entrusted to a depository), and 21(9) (transfer agency function). The AIFM must inform its regulator about the identity of the third party.

1.559 In addition, appropriate cooperation arrangements for the purpose of systemic risk oversight and in line with international standards must be in place between the AIFM's national regulator and the supervisory authorities of the non-EU AIF in order to ensure an efficient exchange of information that allows the AIFM's national regulator to carry out its duties under the AIFMD. The country of the non-EU AIF may not be listed as a Non-Cooperative Country and Territory by the FATF.⁶⁸⁶

⁶⁸⁵ ESMA Regulation (n 29), Art 19(3).

⁶⁸⁶ AIFMD, Art 36(1)(b), (c).

B. Marketing by a non-EU AIFM of non-EU AIFs pursuant to national regimes (Article 42)

Article 42 of the AIFMD permits Member States, without prejudice to Articles 37, 39, and 40, when in force, to allow (unauthorized) non-EU AIFMs to market to professional investors—in their territory only—units or shares of EU and non-EU AIFs they manage subject to the conditions of Article 42. Like the Article 36 conditions, under Article 42(2) Member States may impose stricter rules on the AIFM to the point where it is not permitted to market under Article 42 at all. **1.560**

The conditions of Article 42 are similar to the conditions of Article 36 (ie cooperation agreements must be in place and the AIFs' countries must be FATF compliant), provided that the (unauthorized) non-EU AIFM, unlike the authorized EU AIFM under Article 36, is not expected to comply with the AIFMD except for Articles 22–24 (transparency requirements) and Articles 26–30 if the AIF marketed by it pursuant to Article 42 falls within the scope of Article 26(1).⁶⁸⁷ This, therefore, is a mirror image of Article 36(1)(a), except that Article 42 does not impose any of the duties in Article 21(7), (8), or (9) on the non-EU AIFM. **1.561**

Further, Article 42(1), final paragraph provides that if a competent authority of an EU AIF does not enter into the required cooperation arrangements 'within a reasonable period of time', the competent authorities of the Member State where the AIF is intended to be marketed may refer the matter to ESMA, which may act in accordance with the powers conferred on it under Article 19 of the ESMA Regulation. Article 36 of the AIFMD does not provide for such a procedure in relation to EU AIFMs. **1.562**

It would appear, therefore, that the playing field for EU AIFMs and non-EU AIFMs in relation to the marketing of non-EU AIFs is not entirely level. **1.563**

C. Repeal of the national marketing regimes

Article 66(4) of the AIFMD provides for termination of Articles 36 and 42 by a Commission delegated act made pursuant to Article 68(6). The delegated act must be adopted three months after ESMA has given positive advice pursuant to Article 68(1) on terminating the national regimes, if any, made under Articles 36 and 42. **1.564**

ESMA's advice must follow three years after the 22 July 2015 advice relating to extending passporting rights for the marketing of non-EU AIFs by EU AIFMs within the meaning of Article 35 and Articles 37–41. In other words, ESMA must give termination advice by 22 July 2018. **1.565**

5. Marketing to retail investors (Article 43)

Without prejudice to other instruments of EU law, Member States may allow AIFMs to market to retail investors in their territory units or shares of AIFs that they manage in accordance with the AIFMD, irrespective of whether such AIFs are marketed on a domestic or cross-border basis or whether they are EU or non-EU AIFs.⁶⁸⁸ **1.566**

⁶⁸⁷ AIFMD, Art 42(1)(a). Competent authorities and AIF investors referred to in the Articles specified in Art 42(1)(a) are deemed to be those of the Member States where the AIFs are marketed.

⁶⁸⁸ AIFMD, Art 43(1), first paragraph.

- 1.567** If a Member State allows AIFMs to market units or shares of AIFs they manage in accordance with the AIFMD in their territory, stricter requirements may be imposed on the AIFM or the AIF than the requirements applicable to the AIFs marketed to professional investors in their territory in accordance with the Directive.⁶⁸⁹
- 1.568** However, Member States must 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.⁶⁹⁰
- 1.569** Member States that permit the marketing of AIFs to retail investors in their territory must, by 22 July 2014, inform the Commission and ESMA about the types of AIF AIFMs may market to retail investors in their territory and any additional requirements the Member State imposes for the marketing of AIFs to retail investors.⁶⁹¹
- 1.570** Member States must also inform the Commission and ESMA of any subsequent changes with regard to the information referred to in paragraph 1.569.⁶⁹²

X. Competent Authorities and Supervisor Powers

1. General

- 1.571** Chapter IX (competent authorities) of the AIFMD contains two sections: Section 1 (designation, powers, and redress procedures)⁶⁹³ and section 2 (Cooperation between different competent authorities).⁶⁹⁴

2. Designation, powers, and redress procedures

A. General

- 1.572** Section 1 of Chapter IX of the AIFMD contains provisions regarding the designation, responsibilities, and powers of competent authorities in the Member States, as well as the powers and competences of ESMA.⁶⁹⁵

B. Powers of the competent authorities in the Member States

- 1.573** The competent authorities in the Member States have the power to:
- have access to any document in any form and to receive a copy of it;
 - require information from any person related to the activities of the AIFM or the AIF and if necessary to summon and question a person with a view to obtaining information;
 - carry out onsite inspections with or without prior announcements;
 - require existing telephone and existing data traffic records;

⁶⁸⁹ AIFMD, Art 43(1), second paragraph, first sentence.

⁶⁹⁰ AIFMD, Art 43(1), second paragraph, second sentence.

⁶⁹¹ AIFMD, Art 43(2), first paragraph.

⁶⁹² AIFMD, Art 43(2), second paragraph.

⁶⁹³ AIFMD, Arts 44–49.

⁶⁹⁴ AIFMD, Arts 50–55.

⁶⁹⁵ AIFMD, Arts 44–47.

- (e) require the cessation of any practice contrary to the provisions adopted in the implementation of the AIFMD;
- (f) request the freezing or the sequestration of assets;
- (g) request the temporary prohibition of professional activity;
- (h) require authorized AIFMs, depositaries, or auditors to provide information;
- (i) adopt any type of measure to ensure that AIFMs or depositaries continue to comply with the requirements of the AIFMD applicable to them;
- (j) require the suspension of the issue, repurchase, or redemption of units in the interest of the unit-holders or of the public;
- (k) withdraw the authorization granted to an AIFM or a depositary;
- (l) refer matters for criminal prosecution;
- (m) request that auditors or experts carry out verifications or investigations.⁶⁹⁶

C. Powers of ESMA

ESMA may request the competent authority or competent authorities to take any of the following measures, as appropriate: **1.574**

- (a) prohibit the marketing in the EU of units or shares of AIFs managed by non-EU AIFMs or of non-EU AIFs managed by EU AIFMs (i) without authorization (Article 37 of the AIFMD),⁶⁹⁷ (ii) without notification (Articles 35, 39, and 40),⁶⁹⁸ or (iii) without being allowed to do so by the relevant Member States (Article 42);⁶⁹⁹
- (b) impose restrictions on non-EU AIFMs relating to the management of an AIF in case of excessive concentration of risk in a specific market on a cross-border basis;
- (c) impose restrictions on non-EU AIFMs relating to the management of an AIF where its activities potentially constitute an important source of counterparty risk to a credit institution or other systemically relevant institutions.⁷⁰⁰

ESMA may only take these measures if: (i) a substantial threat exists, originating or aggravated by the activities of AIFMs, to the orderly functioning and integrity of the financial markets or to the stability of the financial system in the EU with cross-border implications; (ii) the relevant competent authorities have not taken (adequate) measures to address the risk.⁷⁰¹ **1.575**

3. Cooperation between different competent authorities

Section 2 of Chapter IX of the AIFMD contains provisions on (i) the obligation of the competent authorities to cooperate with each other and with ESMA and the ESRB, (ii) the transfer and retention of personal data, (iii) disclosure of information to third countries, (iv) exchange of information relating to the potential systemic consequences of AIFM activity, and (v) cooperation in supervisory activities.⁷⁰² Section 2 concludes with a provision on dispute settlement.⁷⁰³ **1.576**

⁶⁹⁶ AIFMD, Art 46(2).

⁶⁹⁷ See paras 1.161–1.175.

⁶⁹⁸ See paras 1.10, 1.537–1.538, 1.550–1.551, 1.556.

⁶⁹⁹ See paras 1.560–1.563.

⁷⁰⁰ AIFMD, Art 47(4).

⁷⁰¹ AIFMD, Art 47(5).

⁷⁰² AIFMD, Arts 50–54.

⁷⁰³ AIFMD, Art 55.

- 1.577** In case of disagreement between competent authorities of Member States on an assessment, action, or omission of one competent authority in areas where the AIFMD requires cooperation or coordination between competent authorities from more than one Member State, competent authorities may refer the matter to ESMA which may act in accordance with the powers conferred on it under Article 19 of the ESMA Regulation (settlement of disagreements between competent authorities in cross-border situations).⁷⁰⁴

XI. Transitional and Final Provisions

- 1.578** Chapter X of the AIFMD contains several transitional and final provisions, inter alia on the exercise of the Commission's powers to adopt delegated acts, revocation of the power to adopt delegated acts by the European Parliament or the Council, objections to delegated acts by the European Parliament and the Council, assistance of ESMA to the Commission in developing delegated acts, transitional provisions, amendments to other directives, transposition of the AIFMD into national law (by 22 July 2013⁷⁰⁵), and review and entry into force of the AIFMD (21 July 2011⁷⁰⁶).⁷⁰⁷

⁷⁰⁴ AIFMD, Art 55.

⁷⁰⁵ AIFMD, Art 66.

⁷⁰⁶ AIFMD, Art 70.

⁷⁰⁷ AIFMD, Arts 56–71.