

## Directive 2011/61/EU on Alternative Investment Fund Managers

The following is a summary of certain relevant provisions of the Directive 2011/61/EU on Alternative Investment Fund Managers (the “**Directive**”) of June 8, 2011 along with ESMA’s draft technical advice to the Commission on possible implementing measures of the Directive as of July 13, 2011.

This summary does not purport to be exhaustive and is based on the information available at the time of the publication. Although we have made every effort to ensure accuracy of the information hereafter, we do not guarantee the completeness and correctness and readers should always obtain professional advice before deciding to take any action (or not, as the case may be) in relation to the information contained herein. Please note in particular that all summaries relating to ESMA's technical draft advice for Level II (hereinafter marked in blue) are very preliminary and only issued as per the consultation, hence subject to further changes.

## Scope (Art. 2)

The Directive is applicable to:

- (i) all EU AIFM, which manage one or more alternative investment funds (AIF) (see definition below) irrespective of whether the AIF is an EU AIF or a non-EU AIF;
- (ii) all non-EU AIFM, which manage one or more EU AIF; and
- (iii) all non-EU AIFM, which market one or more AIF in the EU, irrespective of whether the AIF is an EU AIF or a non-EU AIF.

“**AIF**” is defined as any collective investment undertaking, including investment compartments thereof which is not a UCITS fund and 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. It is unclear whether the criteria “from a number of investors” would exclude funds which have only one investor (but which in theory could also have several investors) (Art. 4(1)(a)).

**"AIFM"** is defined as any legal person whose regular business is the assumption of portfolio and/or risk management functions of one or more AIF (Art. 4(1)(b)).

**"Marketing"** is defined as any direct or indirect offering or placement at **the initiative of the AIFM** or on behalf of the AIFM of units or shares in an AIF it manages to or with investors domiciled in the Union. Hence, investments upon the initiative of the investor would not be covered (Art. 4(1)(x)).

*Exempted and excluded persons*

The Directive does not apply to mere “holding companies” and employee participation schemes or employee saving schemes (Art. 2(3)).

Moreover, AIFM insofar as they manage one or more AIF whose only investors are the AIFM or the parent undertakings or the subsidiaries of the AIFM or other subsidiaries of those parent undertakings, are exempt provided that none of those investors itself is an AIF (Art. 3(1)).

### Lighter regime for smaller AIFMs (Art. 3)

For certain AIFMs, the Directive provides for a lighter regime. This is the case for the following AIFM whose assets under management do not exceed a certain threshold:

- (i) AIFM which either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or

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indirect holding, manage portfolios of AIF whose assets under management, **including any assets acquired through use of leverage**, in total do not exceed a **threshold of EUR 100 million**; or

- (ii) AIFM which either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding, manage portfolios of AIF whose assets under management, **in total do not exceed a threshold of EUR 500 million when the portfolio of AIF consists of AIF that are not leveraged and have no redemption rights exercisable during a period of 5 years following** the date of initial investment in each AIF.

### LEVEL II PROPOSALS:

*Total value of assets approach*

ESMA refers to the **total value of assets approach** in order to calculate the value of the assets under management. However, it is considering other methods, such as acquisition cost of assets held or commitments less realisation at cost (see Notes III.I. 5,6,7).

*Frequency of valuation*

In assessing whether the AIFM can avail of the exemption on an ongoing basis, ESMA considered whether the assets under management should be calculated at one point in time i.e. the end of the calendar year. An alternative approach would involve taking an average of assets under management over the period, or calculating the total value of the assets under management on a more frequent basis, for example quarterly.

It is considered that taking a single "snap shot" of assets under management on a particular day in a calendar year would not be sufficient to properly assess the AIFM's position in relation to the threshold. ESMA considers that it is very possible that the value of each AIF's underlying assets could change constantly depending on the investment strategy, market exposure and level of leverage employed. Therefore, ESMA proposes that AIFMs should monitor their total assets under management on a continuous basis to assess whether they can continue to avail of the exemption.

ESMA proposes that the threshold should be calculated annually using net asset value of AIFs and that the AIFM would monitor (but not re-calculate) their asset under management on at least a quarterly basis to establish whether a more frequent calculation would be required.

*Monitoring*

For such purposes, ESMA is proposing, AIFMs should implement and apply procedures **to monitor the value of total assets under management** taking into account subscription and redemption activity or where applicable capital drawdowns and capital distributions and, recent net asset value calculations for each AIF (see Box 1 No. 4).

Where the total value of assets under management exceeds the threshold the AIFM should notify the competent authority **without delay** stating whether the situation is considered to be of a temporary nature. The situation should not be considered to be of a temporary nature if it is likely to continue for a period in excess of three months. At the end of the three month period the AIFM should recalculate the threshold (see Box 1 No. 5).

ESMA proposes that competent authorities should have the right to examine whether the AIFM calculates and monitors

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<i>Cross holding investments</i>	<p>the total assets under management correctly (see Box 1 No. 6).</p> <p>With respect to cross-holdings, ESMA is proposing to give AIFMs the option to exclude <b>cross holding investments</b> by AIFs in other AIFs under management from the calculation of the total value of assets under management due to the fact that on a look-through basis, there is only one set of underlying assets which should be included in assets under management. The same should apply to a compartment of an AIF which invests in another compartment of that same AIF.</p>
<i>Leverage</i>	<p>For purposes of the exemption “leverage” is defined 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 (Art. 4(1)(v)). According to the recitals (referring explicitly to private equity funds) leverage existing purely at the level of the portfolio company is not meant to be included when referring to leverage.</p> <p><u><b>LEVEL II PROPOSALS:</b></u></p> <p>It is proposed that the AIFM must include assets acquired through leverage when calculating the total value of assets under management. Hence, it seems that financing not exposures the AIF is not included (see also page 43).</p>
<p><i>Registration for smaller funds</i></p> <p><i>Content of the obligation to register with national competent authorities and suitable mechanisms for gathering information</i></p>	<p>With respect to such “smaller” AIFM, the Directive foresees that they shall at least be subject to a <b>registration</b> with the competent authorities of its home Member State and provide information on the main instruments in which they are trading and on the principal exposures and most important concentrations of AIF they manage. Member States are also free to adopt stricter rules with respect to such “smaller” AIFM.</p> <p><u><b>LEVEL II PROPOSALS:</b></u></p> <p>ESMA provides that the following must be provided:</p> <ul style="list-style-type: none"> <li>(i) Information regarding the identity of the AIFs that it manages should include the total value of assets under management.</li> <li>(ii) For information regarding the investment strategies of the AIFs the AIFM should provide the offering document or a relevant extract from the offering document. However, ESMA acknowledges that not all types of AIFM may have an up-to-date offering document (e.g. private equity or venture capital funds often raise money through negotiations with potential investors). Therefore it should be sufficient if the AIFM provides a general description to the investment strategy which should at least include: <ul style="list-style-type: none"> <li>• the main categories of assets in which the AIF will invest;</li> <li>• any industrial, geographic or other market sectors or specific classes of assets which are the focus of the investment strategy; and</li> </ul> </li> </ul>

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<p><i>Opt-in</i></p> <p><i>Opt-in procedure</i></p>	<ul style="list-style-type: none"> <li>• a description of the AIF's borrowing or leverage policy.</li> </ul> <p>Updated information referred to Art. 3(3)(c) should be provided on a quarterly basis. The information provided on a regular basis pursuant to Art. 3(3)(d) should be provided at least on an annual basis. However, competent authorities may require such information on a more frequent basis.</p> <p>Such "smaller" AIFM (although registered) do not benefit from any of the rights granted under this Directive, unless the AIFM chooses to <b>opt-in</b> (which is possible) in which case the entire Directive, subject to the exceptions set forth herein, shall be applicable to those AIFM. However, many of the exceptions included earlier the Parliament's draft for smaller funds are no longer included.</p> <p><u><b>LEVEL II PROPOSALS:</b></u></p> <p>ESMA is proposing AIFMs choosing to opt-in under the Directive should contact their home competent authority and follow the application procedure pursuant to Art. 7 and 8. Such AIFMs which were previously registered with a competent authority under the opt-in provisions and which elect for authorisation should submit all documents set out in Art. 7, which have not been previously been submitted for registration purposes provided that there has been no material change to the information previously submitted.</p> <p>AIFMs which are authorised under the Directive and fall below the threshold set out in Art. 3(2) (i) may notify the competent authority that it intends to remain authorised under the Directive in accordance with the opt-in provisions (however, they are not obliged to make such notification) or (ii) should demonstrate to the competent authority that it will remain below the threshold and seek revocation of its authorisation.</p>
<p><b>Determination of the AIFM subject to authorisation (Art. 5)</b></p>	<p>Pursuant to the Directive, each AIF managed within the scope of the Directive shall have <b>a single AIFM</b>, which shall be responsible for ensuring compliance with the requirements of the Directive. The AIFM shall be either:</p> <ul style="list-style-type: none"> <li>(i) an external manager, which is the legal person appointed by the AIF or on behalf of the AIF and which through this appointment is responsible for managing the AIF (i.e. portfolio and risk management); or</li> <li>(ii) where the legal form of the AIF permits an internal management and where the AIF's governing body chooses not to appoint an external AIFM, the AIF itself, which shall then be authorised as AIFM.</li> </ul> <p>We understand that for instance in a classical limited partnership structure where the general partner would be acting on behalf of the limited partnership one could appoint an external manager acting as AIFM. It is expected that fund sponsors will in future have <u>one</u> AIFM for several funds and not – as has often been the case in the past – one manager for each fund.</p>

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Authorisation of AIFM (Art. 6 et seq.)	No AIFM may manage one or more AIF unless it has been authorised in accordance with the Directive. An authorised AIFM has to comply with the conditions for authorisation established in the Directive at all times. In order to obtain an authorisation the following conditions must be met in particular:
Conditions	<ul style="list-style-type: none"> <li>(i) the relevant competent authorities are satisfied that the AIFM will be able to fulfil the conditions of the Directive;</li> <li>(ii) the AIFM has sufficient initial capital and own funds (see Art. 9);</li> <li>(iii) the persons who effectively conduct the business of an AIFM are of sufficiently good repute and are sufficiently experienced also in relation to the investment strategies pursued by the AIF managed by the AIFM;</li> <li>(iv) the shareholders or members of the AIFM that have qualifying holdings (more than 10% of the capital or voting rights) are suitable taking into account the need to ensure the sound and prudent management of the AIFM; and</li> <li>(v) the head office and the registered office of the AIFM are located in the same Member State.</li> </ul>
Procedure, timing	<p>The competent authorities of the home Member State of the AIFM shall inform the applicant in writing <b>within three months</b> of the submission of a complete application, whether or not authorisation 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.</p> <p>AIFM may start managing AIF with investment strategies described in the application in their home Member State as soon as the authorisation is granted, but not earlier than <b>one month after having</b> submitted any missing information.</p>
Subsequent changes	<p>In case of changes after <i>submission for authorisation</i>, the AIFM must, before implementation, notify the competent authorities of the home Member State of the AIFM in respect of any material changes to the conditions for initial authorisation, in particular material changes to the information provided in accordance with Art. 7.</p> <p>If the competent authorities of the relevant home Member State decide to impose restrictions or reject those changes, they shall, within one month of receipt of that notification, inform the AIFM. The competent authorities may prolong this period for up to one additional month. If the relevant competent authorities do not oppose the changes within the relevant assessment period, they may be affected.</p>
Capital requirements (Art. 9)	<p>An AIFM which is an <b>internally managed</b> AIF must have an initial capital of at least EUR 300,000 (Art. 9(1)).</p> <p>Where an AIFM is appointed as <b>external manager</b> of one or more AIF, the AIFM shall have an initial capital of at least EUR 125,000 (Art. 9(2)).</p> <p>Where the value of the portfolios of AIF managed by the AIFM exceeds EUR 250 million, the AIFM shall provide an additional amount of own funds. That additional amount of own funds shall be equal to 0.02% of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million but the required total of the initial capital and the additional amount must not, however, exceed EUR 10 million (Art. 9(3)).</p>

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For the purpose of such capital requirements any AIF managed by the AIFM, including AIF for which the AIFM has delegated one or more functions in accordance with the Directive **but excluding any AIF portfolios that the AIFM is managing under delegation**, shall be deemed to be the portfolios of the AIFM.

Irrespective of the amount of the requirements set out above, the own funds of the AIFM shall never be less than 25% of the average costs of the AIFM (Art. 9(5)).

In addition, to cover potential professional liability risks resulting from activities AIFMs may carry out pursuant to the AIFM Directive, both internally managed AIFs and external AIFM shall either:

- (a) have additionally own funds which are appropriate to cover potential liability risks arising from professional negligence; or
- (b) hold a professional indemnity insurance against liability arising from professional negligence which is appropriate to the risks covered.

Own funds, including any additional funds as referred to in point (a) of the above-mentioned passage, shall be invested in **liquid assets or assets readily convertible to cash in the short term** and shall not include speculative positions.

### LEVEL II PROPOSAL:

*Risk exposure on additional own funds and professional indemnity insurance (Art. 9(7))*

Art. 9(7) serves to cover the potential liabilities arising from professional negligence. Such potential liability risks in particular might be risks in relation to:

- fraud (losses due to dishonest, fraudulent or malicious acts by relevant persons);
- investors, products & business practices, e.g. (i) negligent losses of documents evidencing title of assets of the AIF, (ii) misrepresentations and misleading statements by the AIFM or (iii) negligent acts, errors or omissions by the AIFM);
- business disruption, system failures and process management.

*Additional own funds*

The advice provides two options for calculating additional own funds to cover potential liability risks:

#### Option 1

The first option is based on the variable assets under management. Thereafter, the additional own funds requirement for liability risk is equal to 0.01% of the value of the portfolios of AIF managed by the AIFM.

#### Option 2

The second option additionally takes into account the variable income. This option is therefore partially based on the

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approach taken in Directive 2006/48/EC (Basic Indicator Approach) and includes the assumption that liability risks may not only rise with the value of the AIF's portfolio but also with the income of the AIFM. After this second option, the additional own funds requirements for liability risk is equal to 0.0015% of the value of the portfolios of AIF managed by the AIFM plus 2% of the relevant income (i.e. the sum of all income received in relation to the collective portfolio management activities of the AIFM subtracting the sum of commissions and fees payable in relation to collective portfolio management activities calculated as average over three years).

The own funds requirement is recalculated and adjusted if necessary at the end of each financial year. The Member States may authorise the AIFM to lower the percentage to 0.008% (Option 1) or to lower the percentage in relation to the relevant income to 1% (Option 2) if the AIFM can demonstrate that the liability risk still is adequately captured.

As an alternative to the requirements of implementing measures on additional own funds to cover liability risks, the AIFM may take out and maintain at all times professional indemnity insurance, complying amongst others with the following requirements:

- (i) The minimum coverage of the insurance per claim must at least equal the higher of the following amounts:
  - 0.75% of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million, up to a maximum of EUR 20 million;
  - EUR 2 million.
- (ii) The coverage of the insurance for claims in aggregate per year must be adequate for the individual AIFM liability risk. The minimum coverage of the insurance for all claims in aggregate per year must at least equal the maximum of the following amounts:
  - 1% of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million up to a maximum of EUR 25 million;
  - EUR 2.5 million;
  - the amount calculated according the requirements for calculating additional own funds to cover potential liability risks (see above).

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### Operating conditions (Art. 12 et seq.)

#### *General principles / conflicts of interest*

AIFM must meet certain operating conditions on an ongoing basis, e.g.

- acting honestly, with due skill, care and diligence, fairly and in the best interests of the AIF or the investors of the AIF and the integrity of the market;
- employ effectively the resources and procedures that are necessary for the proper performance of its business activities;
- take all reasonable steps to avoid conflicts of interests and, when they cannot be avoided, to identify, prevent, manage and monitor conflicts of interest from adversely affecting the interests of the AIF and its investors and to ensure that the AIF it manages are fairly treated;
- comply with all applicable regulatory requirements.

No investor in an AIF may obtain a preferential treatment, unless this is disclosed in the relevant AIF's rules or instruments of incorporation.

#### LEVEL II PROPOSAL:

In line with the UCITS approach (Art. 22(2) and (4) UCITS Level II) AIFM should take appropriate measures to avoid malpractices that might reasonably be expected to affect the stability and integrity of the market. AIFM should further establish appropriate procedures and act in such way as to prevent undue costs being charged to the AIF and investors.

#### *Due diligence requirements*

The AIFM shall comply with the following **due diligence requirements**:

1. AIFM should ensure a high level of diligence in the selection and ongoing monitoring of investments, in the best interests of the AIF, its investors and the integrity of the market.
2. AIFM should ensure that they have adequate knowledge and understanding of the assets in which the AIF are invested.
3. AIFM should establish written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the AIF are carried out in compliance with the objectives, investment strategy and, where applicable, risk limits of the AIF. The due diligence processes and procedures should be regularly reviewed and updated.
4. Where applicable to the type of asset (i.e. for PE) the AIFM should in addition to the requirements in paragraph 1 to 3
  - (a) set out and update a business plan consistent with the duration of the AIF and market conditions;



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### Execution of decisions

- (b) seek and select possible transactions consistent with the plan referred to under point (a);
- (c) assess the selected transactions in consideration of opportunities, if any, and overall related risks, all relevant legal, fiscal, financial or other value affecting factors, human and material resources as well as strategies, including exit strategies;
- (d) perform any due diligence activities related to the transactions prior to arranging execution;
- (e) monitor the management performance of the AIF with respect to the plan referred to under point (a).

5. AIFM should retain records on the activities performed pursuant to paragraph 4 for a period of at least five years.

Paragraphs 1 to 3 contain general principles for due diligence AIFM have to comply with, irrespective of the assets in which the AIF is invested. **Paragraphs 4 to 5 set out additional due diligence requirements when investing in long duration, less liquid assets such as real estate or partnership interests, typically carry out the investment on behalf of the AIF after a comprehensive and detailed due diligence process and extensive negotiation of the agreement.**

ESMA proposes with respect to the **execution of decisions** to deal on behalf of the managed AIF, that the AIFM, amongst others, should

- (i) act in the best interest of the AIF or the investors of the AIF they manage when executing decisions to deal on behalf of the managed AIF in the context of the management of their portfolio.
- (ii) whenever the AIFM buy or sell financial instruments or other assets and for the purpose of bullet point one (see above), AIFM shall take all reasonable steps to obtain the best possible result for the AIF or the investor of the AIF, taking into account the prize, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. The relative importance of such factors shall be determined by reference to certain criteria further set out in the advice.

While point (i) is proposed to apply to all types of AIF, point (ii) shall only apply to those types of AIF which acquire or sell financial assets for which best execution is relevant. According to ESMA, best execution is not relevant when the AIFM, *“for example, invests in real estate or partnership interests and the investment is made after extensive negotiations on the terms of the agreement”*. In this case there is no choice of different investment “execution venues” (i.e. regulated markets). The AIFM should be able to demonstrate to the competent authority and auditors that there is no choice of different “markets” (see Note IV.II. 21). PE-Funds typically invest in corporations (and not partnership interests) but the have also no choice of “execution venues”.

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### Inducements

With respect to **inducements** ESMA advises that the following criteria shall be considered:

1. AIFM should not be regarded as acting honestly, fairly and professionally in accordance with the best interests of the AIF if, in relation to the activities of collective portfolio management of AIFs, they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit, other than the following:
  - (a) a fee, commission or non-monetary benefit paid or provided to or by the AIF or a person on behalf of the AIF;
  - (b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the AIFM can demonstrate that the following conditions are satisfied:
    - (i) The existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the investors of the AIF in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant service;
    - (ii) The payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service and not impair compliance with the AIFM's duty to act in the best interests of the AIF.
  - (c) proper fees which enable or are necessary for the provision of the relevant service, including custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts with the AIFM's duties to act honestly, fairly and professionally in accordance with the best interests of the AIF.
2. AIFM should be permitted, for the purpose of paragraph 1(b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that the AIFM undertakes to disclose further details at the request of the investor and provided that it honours that undertaking.

### Fair treatment

With respect to a **fair treatment by an AIFM** the advice proposes:

Fair treatment by an AIFM **requires** (Option 2: "**includes**") that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors.

ESMA states that it believes that fair treatment of AIF investors requires that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors. Consequently, preferential treatment of one investor does not necessarily mean that it has an overall material disadvantage to other investors. However, if a preferential treatment has such an effect, it would be an unfair treatment and therefore not be allowed. In contrast, preferential treatment that has no overall material disadvantage to other investors is allowed if this is disclosed in the relevant AIF's rules or instruments of incorporation (Art. 12(1)).

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If an AIF offers different share classes, in particular with regard to the redemption deduction, the minimum investment amount or the management fees, there is a preferential treatment of the investors of one share class (e.g. granting a higher redemption deduction) over investors of another share class. However, this would not be an unfair treatment as the preferential treatment of the investors of one share class has no overall material disadvantage to investors of another share class.

Furthermore, it is not unfair either to grant preferential treatment to seed investors as this generally has no overall material disadvantage to investors that join the fund later where seed investors take an additional investment risk in relation to the start up – unlike the following investors.

ESMA considers that there are different methods to prevent an unfair treatment of investors, e.g. the so-called “most favoured nation clause”. According to the November 2010 IOSCO report “Private Equity Conflicts of Interest” (page 10), “Private Equity funds are sometimes established subject to a most favoured nation clause which may provide less influential investors with the ability to benefit from more favourable terms negotiated by larger investors, thereby providing consistency among all investors, although in many instances an investor’s most favoured nation rights are limited to terms of those investors with an equal or smaller commitment.”

An unfair treatment would also be prevented in the following example: An investor obtains preferential treatment at a time other investors have already invested in the AIF. There is no “most favoured nation clause” but these other investors are informed of the preferential treatment and have the right to redeem their shares or units free of cost.

ESMA is also considering corresponding rules in UCITS and MiFID, acknowledging the need expressed by the Commission to target an appropriate level of consistency with the provisions of such directives. However, ESMA seems to believe that it is appropriate to indicate that fair treatment may include that no investors may obtain a preferential treatment that has a material overall disadvantage to other investors, but not provide a definition which comprehensively defines fairness.

### Risk management (Art. 15)

The AIFM shall functionally and hierarchically separate the functions of risk management from the operating units, including the portfolio management. It must implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or can be exposed. It remains to be seen what exactly this will mean for private equity fund managers.

The AIFM shall set a maximum level of leverage which the AIFM may employ on behalf of each AIF it manages as well as the extent of the right of the re-use of collateral or guarantee that could be granted under the leveraging arrangement.

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Measures on risk management

Permanent risk management function

### LEVEL II PROPOSAL:

ESMA's advice on the role of the permanent risk management function is based on Art. 12 of the UCITS implementing directive (2010/43/EU) and revisions have been made to this article to bring it into line with the terminology of the AIFM Directive and to make it relevant to the many types of AIFM/AIF that will fall under its scope.

ESMA proposes that AIFM shall ensure that the risk management policy referred to above states the terms, contents and frequency of reporting of the risk management function to those charged with governance, to senior management and, where it is appropriate, the supervisory function.

The advice on risk management policy should apply to all type of AIFM however ESMA recommends that AIFM take into account the nature, scale and complexity of their business and of the AIF it manages when setting the risk management policy.

ESMA proposes that the AIFM establishes and maintains a **permanent risk management function** as follows:

- (i) implement effective risk management policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks relevant to each AIF's investment strategy, to which each AIF is or may reasonably be exposed;
- (ii) ensure that the risk profile of the AIF disclosed to investors in accordance with Art. 23(4)(c), is consistent with the risk limits that have been set (see also page 15);
- (iii) monitor compliance with the risk limits and notify the AIFM's governing body and where it exists the AIFM's supervisory function in a timely manner when it considers the AIF's risk profile is inconsistent with these limits or where it is aware there is a material risk that it will be inconsistent with these limits;
- (iv) provide the following regular updates to the governing body of the AIFM and where it exists the AIFM's supervisory function at a frequency which is in accordance with the nature, scale and complexity of the AIF and/or the AIFM's activities:
- (v) the consistency between and the compliance with, the risk limits and the risk profile of that AIF as disclosed to investors in accordance with Art. 23(4)(c); and
- (vi) the adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have or will be taken in the event of any actual or anticipated deficiencies; and
- (vii) provide regular updates to the senior management outlining the current level of risk incurred by each managed AIF and any actual or foreseeable breaches to any risk limits, so as to ensure that prompt and appropriate action can be taken.

The AIFM shall ensure that the permanent risk management function shall have the necessary authority and access to

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### *Risk management policy*

all relevant information necessary to fulfil the tasks set out above.

AIFM shall establish, implement and maintain an adequate and documented **risk management policy** which identifies all the relevant risks to which the AIF they manage are or might be exposed to.

AIFM shall address at least the following elements in the risk management policy:

- (i) the techniques, tools and arrangements that enable them to comply with the obligations set out above;
- (ii) the techniques, tools and arrangements that enable the assessment and monitoring of the liquidity risk of the AIF, under normal and exceptional liquidity conditions including through the use of regularly conducted stress tests;
- (iii) the allocation of responsibilities within the AIFM pertaining to risk management;
- (iv) the risk limits (see below) and a justification of how these are aligned with the risk profile of the AIF disclosed to investors in accordance with Art. 23(4)(c); and
- (v) where the risk management function is not functionally or hierarchically separate the AIFM shall include a description of the safeguards (see below) that allow for an independent performance of the risk management function. This description shall include:
  - the nature of the conflict of interest;
  - the remedial measures put in place;
  - the reason why this measure should be responsibly expected to result in an independent performance of the risk management function; and
  - how the AIFM expects to ensure that the safeguards are consistently effective.

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*Assessment, monitoring and review (Box 27)*

ESMA proposes that:

1. AIFM shall assess, monitor and periodically review the adequacy and effectiveness of the risk management policy and any measures to deficiencies, as well as the level of compliance and the separation of the risk management function:
2. AIFM shall notify the competent authorities of their home Member State of any material changes to the risk management policy and of the arrangements, processes and techniques.
3. AIFM shall ensure that the periodic review in accordance with paragraph 1 is carried out on a regular basis (at least annually or upon changes) considering the nature, scale and complexity of its activities.

*Measurement / management of risk (Box 28)*

With respect to the **measurement and management of risk**, the

1. AIFM shall adopt adequate and effective arrangements, processes and techniques in order to:
  - (a) identify, measure, manage and monitor at any time the risks to which the AIF under their management are or might be exposed to including those sources of risk the AIFM incurs on behalf of the AIF; and
  - (b) ensure compliance with the identified risk limits (see page 15).
2. Those arrangements, processes and techniques referred to in paragraph 1 shall be proportionate to the nature, scale and complexity of the business of the AIFM and of the AIF they manage and shall be consistent with the AIF risk profile as disclosed to investors in accordance with Art. 23(4)(c).
3. For the purposes of paragraph 1, ESMA proposes certain actions for each AIF that the AIFM manages, including e.g.:
  - (a) conducting periodic back-tests;
  - (b) conducting periodic stress tests and scenario analyses;
  - (c) ensuring that the current level of risk complies with the determined risk limits;
  - (d) establishing remedial actions for the event of actual or anticipated breaches of the risk limit policy and procedures of the AIF; and
  - (e) ensuring that there are appropriate liquidity management processes for each AIF.

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### *Risk limits (Box 29)*

With respect to **risk limits** ESMA proposes that:

1. AIFM shall establish and implement quantitative and/or qualitative risk limits for each AIF they manage, taking into account all relevant risks. Where only qualitative limits are set the AIFM shall be able to justify this approach to the relevant competent authority.
2. The qualitative and quantitative risk limits for each AIFM shall, at least, cover the following risks:
  - (a) market risks;
  - (b) credit risks;
  - (c) liquidity risks;
  - (d) counterparty risks; and
  - (e) operational risks.

When setting risk limits AIFM shall take into account the strategies and assets employed in respect of each AIF it manages as well as the national rules applicable to each of those AIF. These risk limits should be aligned with the risk profile of the AIF as disclosed to investors in accordance with Art. 23(4)(c) and approved by the governing body.

### *Functional and hierarchical separation of the risk management function (Box 30)*

ESMA proposes that:

1. The risk management function of an AIFM may be said to be functionally and hierarchically separate from the operating units, including the portfolio management function, where all the following conditions are satisfied:
  - (a) Those engaged in the performance of the risk management function are not supervised by those responsible for the performance of the operating units, including the portfolio management function, of the AIFM;
  - (b) Those engaged in the performance of the risk management function are not engaged in the performance of activities within the operating units, including the portfolio management function;
  - (c) Those engaged in the performance of the risk function are compensated in accordance with the achievement of the objectives linked to that function, independent of the performance of the other conflicting business areas;
  - (d) The remuneration of the senior officers in the risk management functions is directly overseen by the remuneration committee, where the AIFM is sufficiently significant in terms of its size or the size of the AIF it manages, its internal organization and the nature, the scope and the complexity of its activities to have established such a committee; and
  - (e) The separation is ensured up to the governing body of the AIFM.

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1. The functional and hierarchical separation of the functions of risk management in accordance with paragraph 1 shall be reviewed by the competent authorities of the home Member State of the AIFM in line with the principle of proportionality, in the understanding that the AIFM shall in the event be able to demonstrate that specific safeguards against conflicts of interest allow for the independent performance of risk management activities.
2. The governing body of the AIFM, and where it exists the supervisory function, shall review the risk management function in accordance with paragraph 1. Where compliance cannot be achieved the governing body of the AIFM, and where it exists the supervisory function, shall identify material conflicts of interest that may pose a risk to the independent performance of the risk management function. These safeguards shall be documented in the risk management policy and must include (a), (b), (c) and (e) and may also include (d) and (f) where this is proportionate taking into account the nature, scale and complexity of the AIFM:
  - (a) procedures to ensure that the data used by the risk management function in making decisions is reliable and subject to an appropriate degree of control by the risk management function so as to allow for the independent performance of its duties;
  - (b) that staff members engaged in risk management are compensated in accordance with the achievements of the objectives linked to the risk management function, independent of the performance of the business areas in which they are engaged;
  - (c) that the key risk management function is subject to an appropriate independent review to ensure that decisions are being arrived at independently;
  - (d) that there is a review of the risk management function by an independent external party or, where applicable the internal audit function;
  - (e) segregation of conflicting duties; and
  - (f) an appropriately resourced risk committee that reports directly to the AIFM's governing body where the non-independent members of such a committee do not have undue influence over the process.
3. The safeguards referred to in paragraph 3 must be subject to regular review by the governing body of the AIFM, and where it exists the supervisory function, which shall require timely remedial action to be taken to address deficiencies.



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### Remuneration (Art. 13)

The AIFM must have remuneration policies and practices for those categories of staff, including senior management, whose professional activities have a material impact on the risk profiles of AIF they manage, that are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the AIF it manages.

The AIFM shall determine the remuneration policies and practices in accordance with certain principles listed in the Directive and to be further specified by the new European regulatory authority, ESMA. This means in particular:

When establishing and applying the totally remuneration policies (including carried interest), the AIFM must comply with certain principles which are based on the principles already applicable to the financial services sector and which include among many others:

- (i) the remuneration policy may not encourage risk-taking which is inconsistent with the risk profiles fund rules of the AIF;
- (ii) the remuneration of senior officers in risk management in compliance functions must be directly overseen by a remuneration committee;
- (iii) the guaranteed variable remuneration is exceptional and may only occur in the context of high hiring new staff and must be limited to the first year;
- (iv) subject to the legal structure of the AIF a substantial portion which is at least 50% of any variable remuneration shall consist of units or shares of the AIF concerned or equivalent ownership interests unless the management of the AIF accounts only for less than 50 % of the total portfolio managed by the AIFM in which case the minimum of 50% shall not apply;
- (v) a substantial portion, which is at least 40% of the variable remuneration component must be deferred over a period which is appropriate in view of that life cycle and redemption policy of the AIF concerned and is correctly aligned with nature of the risks of the AIFM in question; this period should be a least three to five years; in the case of the variable remuneration component and of a particularly high amount, at least 60% of the amount is deferred.

It is very questionable how all such principals must be interpreted in practice which remains subject to further review. “**Carried Interest**” is defined as a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF and excluding any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF. This definition raises also questions as Carried Interest would typically be a disproportionate profit as a return on a commitment held in the fund.

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### Conflicts of interests (Art. 14)

#### LEVEL II PROPOSAL:

With respect to the **types of conflicts of interests** between the various actors as referred in Art. 14(1) the advice states:

For the purpose of identifying the types of conflicts of interests that arise in the course of managing AIFs, AIFM should take into account, by the way of minimum criteria, the question of whether the AIFM, a relevant person or a person directly or indirectly lined by way of control to the AIFM:

- (i) is likely to make a financial gain, or avoid financial loss, at the expense of the AIF or its investors;
- (ii) 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;
- (iii) has a financial or other incentive to favour (i) the interest of a UCITS, a client or group of clients or another AIF over the interest of the AIF or (ii) the interest of one investor over the interest of another investor or group of investors of the same AIF;
- (iv) carries on the same activities for the AIF and for another AIF, a UCITS or client; or
- (v) 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.

An example for the situation under (i) might be seen in the following: As for private equity funds the final size of the fund is usually agreed during the fund raising process between AIFM and the investors. However, in case no "hard cap" limit of the fund size is agreed, the following conflict may arise: If the management fee is calculated as a percentage of the total amount of committed capital, an increase of the size limit the AIF without any advantage for the investors of the AIF (e.g. no attractive investment possibilities) may rather serve the interest of the managers than the investors' one.

An example for the situation under (ii) might be seen in the following: An AIFM invests in a target company which has been provided with a loan by a relevant person or a person directly or indirectly linked by control of the AIFM. In this case the AIFM may be influenced by the interest of the relevant person in avoiding financial distress of the target company.

Examples for the situation under (iii) might be seen in the following: The AIFM grants an investor "co-investment rights" that differ in terms from those offered to other AIF investors. By special arrangement (so called "side letter"), the AIFM grants an investor redemption rights that are preferential in terms from the general redemption rights given to other investors. A conflict may also arise if the AIFM buys or sells on behalf of the AIF an asset from/to one investor of the AIF, especially if the asset is not negotiated in a regulated market (e.g. non listed company for a private equity AIF).

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*Conflicts of interest policy  
(Boxes 21-24)*

An example for the situation under (iv) might be seen in the following: An AIFM sets up a new AIF with the same or similar strategy of an AIF that has not been fully invested yet and allocates investment opportunities to the new AIF instead of to the preceding AIF.

An example for the situation under (v) might be seen in the following: An AIFM that has invested in a portfolio company and receives from this portfolio company on an ongoing basis fees such as directors' fees, monitoring fees or consultancy fees.

In line with the UCITS (Art. 18 UCITS Level 2) and the MiFID (Art. 22(1) and (2) MiFID Level 2) approach ESMA proposes AIFM should establish, implement and maintain a **conflicts of interest policy**. This policy should identify situations under which activities carried out by the AIFM may constitute conflicts of interest followed by potential risks of damage to the AIF's interests or its investors.

In line with the approach considered in UCITS (Art. 19 UCITS Level 2) and MiFID (Art. 22(3) MiFID Level 2) ESMA proposes AIFM should adopt procedures and measures to ensure that relevant persons engaged in different activities that could involve conflict of interest carry out these activities on an appropriately independent level. This level should be in proportion to the size and organisation of the AIFM and the nature, scale and complexity of its business.

In line with Art. 20(1) UCITS Level 2 and Art. 23 MiFID Level 2 ESMA proposes AIFM should keep and regularly update a record of the types of activities undertaken by or on behalf of the AIFM in which a conflict of interest entailing a material risk of damage to the interests of one or more AIFs or its investors has arisen or, in the case of an ongoing activity, may arise.

In line with the UCITS approach (Art. 21 UCITS Level 2) ESMA proposes AIFM should develop strategies for the exercise of voting rights. However, since the Directive regulates the marketing to professional investors unlike Art. 21(3) UCITS Level 2, a summarized description of the strategies has to be made available to investors only on their request.

**Organisational requirements (Art. 18 et seq.)**

*General guidelines on procedures and organisation*

Besides the general principle that the AIFM shall, at all times, use adequate and appropriate human and technical resources that are necessary for the proper management of AIF, in particular the following organisational requirements must be met:

### LEVEL II PROPOSAL:

With respect to the **general guidelines on procedures and organisation**, ESMA proposes that AIFM complies with the following requirements:

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- (a) to establish, implement and maintain decision-making procedures and an organisational structure which clearly and in a documented manner specifies reporting lines and allocation functions and responsibilities;
- (b) to ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities;
- (c) to establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the AIFM;
- (d) to establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the AIFM as well as effective information flows with any third party involved;
- (e) to maintain adequate and orderly records of their business and internal organisation.

AIFM should 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.

AIFM should establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question.

AIFM should establish, implement and maintain an adequate business continuity policy aimed at ensuring, in the case of an interruption to their systems and procedures, the preservation of essential data and functions, and the maintenance of services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of their services and activities.

AIFM should establish, implement and maintain accounting policies and procedures that enable them, at the request of the competent authority, to deliver in a timely manner to the competent authority financial reports which reflect a true and fair view of their financial position and which comply with all applicable accounting standards and rules.

AIFM should monitor and, on a regular basis, evaluate the adequacy and effectiveness of their systems, internal control mechanisms and arrangements described above and to take appropriate measures to address any deficiencies.

With respect to **resources**, the proposals are based on Art. 5 UCITS Level 2 and set up the following requirements:

1. AIFM should employ sufficient personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them;
2. AIFM should ensure that the performance of multiple functions by relevant persons does not and is not likely to prevent those relevant persons from discharging any particular function soundly, honestly and professionally,

*Resources*

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*Electronic data processing*

3. For the purpose laid down in paragraphs 1 and 2, AIFM should 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.

Regarding **electronic data processing**, the proposals - being in line with Art. 7 UCITS Level 2 - states that AIFM should (i) make appropriate arrangements for suitable electronic systems so as to permit a timely and proper recording of each portfolio transaction or subscription or, where relevant, redemption order and (ii) ensure a high level of security during the electronic data processing as well as integrity and confidentiality of the recorded information, as appropriate.

In line with the UCITS approach (Art. 8 UCITS Level 2), AIFM should establish, implement and maintain **accounting policies and procedures** to ensure that the calculations of the net asset value is carried out according to Art. 19. In particular, the

1. AIFM should employ accounting policies and procedures as referred to above (general requirements on procedures and organization) so as to ensure the protection of investors. AIF accounting shall be kept in such a way that all assets and liabilities of the AIF can be directly identified at all time. If an AIF has different investment compartments, separate accounts shall be maintained for those investment compartments.
2. AIFM should establish, implement and maintain accounting policies and procedures so as to ensure the calculation of the net asset value of each AIF is accurately effected on the basis of the accounting.

*Control by senior management and supervisory function*

With respect to the **control by senior management and supervisory function**, ESMA states the following:

1. When allocating functions internally, AIFM should ensure that senior management and, where appropriate, the supervisory function, are responsible for the AIFM's compliance with its obligations under the Directive.
2. The AIFM should ensure that its senior management
  - a) is responsible for the implementation of the general investment policy for each managed AIF, as defined, where relevant, in the fund rules, the instruments of incorporation, the prospectus or offering documents;
  - b) approves or oversees the approval of the investment strategies for each managed AIF;
  - c) is responsible for ensuring that valuation procedures according to Art. 19 are established;
  - d) is responsible for ensuring that the AIFM has a permanent and effective compliance function, even if this function is performed by a third party;
  - e) ensures and verifies on a periodic basis that the general investment policy, the investment strategies and the risk limits of each managed AIF are properly and effectively implemented and complied with, even if the risk management function is performed by third parties;
  - f) approves and reviews on a periodic basis the adequacy of the internal procedures to for undertaking investment

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<p><i>Permanent function</i></p> <p><i>compliance</i></p>	<p>decisions for each managed AIF, so as to ensure that such decisions are consistent with the approved investment strategies;</p> <p>g) approves and reviews on a periodic basis the risk management policy and arrangements, processes and techniques for implementing that policy including the risk limit system for each managed AIF;</p> <p>h) is responsible for establishing and applying a remuneration policy in line with Annex II of the Directive.</p> <p>3. The AIFM should also ensure that its senior management and, where appropriate, its supervisory function should:</p> <p>a) assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations in the Directive;</p> <p>b) take appropriate measures to address any deficiencies.</p> <p>4. AIFM should ensure that their senior management receives on a frequent basis, and at least annually, written reports on matters of compliance, internal audit and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.</p> <p>5. AIFM should ensure that their senior management receives on a regular basis reports on the implementation of investment strategies and of the internal procedures for taking investment decisions referred to in points (b) to (e) of paragraph 2.</p> <p>6. AIFM should ensure that the supervisory function, if any, receives on a regular basis written reports on the matters referred to in paragraph 4.</p> <p>With respect to the <b>permanent compliance function</b>, ESMA's approach based upon UCITS (Art. 10 UCITS Level 2) and MiFID (Art. 6 MiFID Level 2) and states the following:</p> <p>1. AIFM should establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the AIFM to comply with its obligations under the Directive, as well as the associated risks, and put in place adequate measures and procedures designed to minimize such risk and to enable the competent authorities to exercise their powers effectively under that Directive. AIFM should 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.</p> <p>2. AIFM should establish and maintain a permanent and effective compliance function which operates independently and which has the following responsibilities:</p> <p>a) to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures, policies and</p>
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## Directive 2011/61/EU on Alternative Investment Fund Managers

### Internal audit function

- procedures put in place in accordance with paragraph 1, and the actions taken to address any deficiencies in the AIFM's compliance with its obligations;
- b) to advise and assist the relevant persons responsible for carrying out services and activities to comply with the AIFM's obligation under the Directive.

3. In order to enable the compliance function referred to in paragraph 2 to discharge its responsibilities properly and independently, AIFM shall ensure that the following conditions are satisfied:
- a) the compliance function must have the necessary authority, resources, expertise and access to all relevant information;
  - b) a compliance officer must be appointed and must be responsible for the compliance function and for any reporting on a frequent basis, and at least annually, to the senior management on matters of compliance, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies;
  - c) the relevant person involved in the compliance function must not be involved in the performance of services or activities they monitor;
  - d) the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so.

However, an AIFM shall not be required to comply with point (c) or point (d) of the first subparagraph where it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of its services and activities, that requirement is not proportionate and that its compliance function continues to be effective.

In line with the UCITS (Art. 11 Level 2) and the MiFID (Art. 8 Level 2) approach ESMA proposes that the AIFM should establish and maintain an **internal audit function** separate and independent from other functions and activities of the AIFM. In particular, ESMA states:

- 1. AIFM should, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of collective portfolio management activities undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the AIFM.
- 2. The internal audit function referred to in paragraph 1 shall have the following responsibilities:
  - a) to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the AIFM's systems, internal control mechanisms and arrangements;
  - b) to issue recommendations based on the result of work carried out in accordance with point (a);
  - c) to verify compliance with the recommendations referred to in point (b);

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d) to report in relation to internal audit matters.

In cases, where the separation and independence should be disproportionate to the scale and complexity of the AIFM's business, the responsibilities of the internal audit function may be carried out by another business unit of the AIFM.

*Personal transactions by relevant persons*

Based on Art. 13 UCITS Level 2, the AIFM requires to establish rules for **personal transactions by relevant persons** that are involved in activities causing potential conflicts of interest, or that have access to inside information or to other confidential information relating to AIF or to transactions with or for AIF. In particular, ESMA proposes that:

AIFM establishes, implements and maintains adequate arrangements aimed at preventing certain activities in the case of any relevant person who is involved in activities that may give rise to a conflict of interest, or who has access to inside information within the meaning of Art. 1(1) of Directive 2003/6/EC or to other confidential information relating to AIF or transactions with or for AIF by virtue of an activity carried out by him on behalf of the management company.

*Recording of portfolio transactions*

With respect to the **recording of portfolio transactions**, ESMA proposes:

AIFM should make without delay for each portfolio transaction relating to AIF a record of information which is sufficient to reconstruct the details of the order and the executed transaction or of the agreement.

*Recording of subscription and redemption orders*

ESMA bases its advice on Art. 15 UCITS Level 2, pursuant to which the AIFM is required to ensure that AIF **subscription and redemption orders are recorded**.

*Retention of records of portfolio transactions and of subscriptions and redemption orders*

Based upon Art. 16 UCITS Level 2 and Art. 51 MiFID Level 2 ESMA proposes that the AIFM is required to ensure the **retention of records of portfolio transactions and of subscription and redemption orders**.

Since the AIFM Directive regulates the marketing to professional investors and not to retail investors, an AIFM should not be required to establish and implement procedures for the reasonable handling of complaints received from investors. This approach is in line with the MiFID regime according to which investment firms only have to establish such procedures for complaints received from retail clients (Art. 10 MiFID Level 2).



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### Valuation (Art. 19)

The AIFM shall ensure that, for each AIF that it manages, appropriate and consistent procedures are established to ensure a proper and independent valuation of the assets of the AIF at least once a year and, in case of a closed-ended AIF, upon each sale and acquisition.

The AIFM shall also ensure that the net asset value per share or unit of AIF is calculated and disclosed to the investors.

### Valuer

The valuation function must be performed by:

- (i) an independent external valuer, being a legal or natural person separate from the AIF, the AIFM and from any other persons with close links to the AIF or the AIFM; or
- (ii) the AIFM itself, **provided that the valuation task is functionally separated from the portfolio management** and the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon the employees is prevented. When the valuation function is not performed by an independent external valuer, the competent authorities of the home Member State of the AIFM may require the AIFM to have its valuation procedures and/or valuations verified by an external valuer or, where appropriate, an auditor.

According to Level I, the AIFM is responsible for the proper valuation of AIF assets, the calculation of the net asset value and the publication of that net asset value. Therefore, in no case shall the AIFM's liability towards the AIF and its investors be affected by the fact that the AIFM has appointed an external valuer.

### LEVEL II PROPOSAL:

### Valuation of the assets of the AIF

ESMA proposes the following **policies and procedures for the valuation of the assets of the AIF:**

1. AIFM should ensure that, for each AIF it manages, written policies and procedures are established, maintained and reviewed which seek to ensure a sound, transparent and appropriately documented valuation process. Without prejudice to requirements under national law, AIFM should ensure that fair, appropriate and transparent valuation methodologies are applied for the AIF they manage in accordance with AIF rules and instruments of incorporation.
2. The policies shall identify and the procedures shall reflect the valuation methodologies that will be used for each of the types of assets in which the AIF may invest according to applicable national law, the AIF rules and the instruments of incorporation. The valuation methodology in respect of the specific type of assets has to identify prior to investment in that type of asset.
3. The policies should set out the obligation, role and duties of all parties involved in the valuation process, including the senior management. The procedures should reflect the organizational structure as set out in the policies.
4. Where an external valuer is appointed, the policies and procedures should set out a process for the exchange of information between the AIFM and the external valuer to ensure that all necessary information required for the purpose of performing the valuation task are provided.
5. Where the valuation function is performed by the AIFM itself, the policies must include a description of the

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*Calculation of net asset value  
per unit or share*

safeguards for functionally independent performance of the valuation task in accordance with Art. 19(4)(b). Such safeguards should include measures to prevent or limit any person from exercising inappropriate influence over the way in which a person carries out valuation activities.

If a model is used to value the assets, the model and its main features should be explained in the valuation policies and procedures. The reason for the choice of the model, the underlying data and assumptions used in the model and the rationale for using it should be appropriately documented. The AIFM shall ensure before using the model that the model is validated by a person with sufficient expertise who has not been involved in the building process of the model. The model should be subject to approval by the senior management. The valuation process should be appropriately documented.

The AIFM should ensure that the policies and procedures and the designated methodologies are applied consistently, taking into account the investment strategy, the type of assets and, if applicable, the existence of different external valuers. The policies and procedures shall be applied across all AIF having the same AIF.

The policies should allow for a review of the policies and procedures, including the valuation methodologies, periodically. The review should be carried out at least annually and prior to the engagement of the AIF with a new investment strategy or a new type of asset that is not covered by the actual valuation policy.

The AIFM should ensure that the values of all assets held by the AIF are fair and appropriate. The AIFM has to document his assessment of the appropriateness and fairness of the individual values. The AIFM must be able to demonstrate that the AIF portfolios have been properly valued.

ESMA proposes the following with respect to the **calculation of net asset value per unit or share**:

1. The AIFM should ensure that the net asset value is calculated on the occasion of each issue or subscription of units or shares but at least once a year.
2. The AIFM should ensure that the procedures and the methodology for calculating the net asset value per unit or share is fully documented. The documentation and its application should be subject to regular verification by the AIFM.
3. The AIFM should ensure that remediate procedures are in place in the event of an incorrect calculation of the net asset value.
4. The AIFM should ensure that the number of units or shares in issue is subject to regular verification at least as often as the unit or share price is calculated.

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	<p>ESMA states that the advice contains only proposals on the procedure for the calculation but not on the methodology of the calculation. The advice does not differentiate between open-ended funds and closed-ended funds.</p> <p>In order to perform as an external valuer, professional guarantees must be furnished, containing the evidence of the external valuers' qualification and capability to perform the valuation. In order to perform this function, the external valuer has to provide sufficient personnel and technical resources, adequate procedures for a proper and independent valuation as well as adequate knowledge and understanding to perform the valuation.</p>
<b>Delegation of AIFM functions / conditions (Art. 20)</b>	<p>The delegation (and sub-delegation) of tasks typically carried out by the AIFM is in particular subject to notification to competent authorities and to the following conditions:</p> <ul style="list-style-type: none"> <li>(i) the AIFM must be able to justify its entire delegation structure with objective reasons;</li> <li>(ii) the delegate may not be conflicted and must dispose of sufficient resources to perform the respective tasks and the persons who effectively conduct the business must be of sufficiently good repute and sufficiently experienced;</li> <li>(iii) where the delegation concerns the portfolio management or the risk management, <b>the mandate must be given only to undertakings which are authorised or registered for the purpose of asset management and subject to supervision.</b> Where this condition cannot be satisfied, delegation may only be given on the condition of prior approval by the competent authorities of the home Member State of the AIFM;</li> <li>(iv) where the delegation concerns the portfolio management or the risk management and is given to a third-country undertaking, <b>in addition to the requirements in point (iii), co-operation between the competent authorities of the home Member State of the AIFM and the supervisory authority of the undertaking shall be ensured;</b></li> <li>(v) the AIFM must be able to demonstrate that the delegate is qualified and capable of undertaking the functions in question, that it was selected with all due care and that the AIFM is in a position to monitor effectively at any time the delegated activity, to give at any time further instructions to the delegate and to withdraw the delegation with immediate effect when this is in the interest of investors.</li> </ul> <p>The AIFM shall review the services provided by each delegate on an ongoing basis.</p>
<i>Liability in case of delegation</i>	<p>In no case shall the AIFM's liability towards the AIF and its investors be affected by the fact that the AIFM has delegated functions to a third party, or by any further sub-delegation, nor shall the AIFM delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity.</p>

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General principles on delegation

### LEVEL II PROPOSAL:

In line with the MiFID approach (Art. 14 MiFID Level 2) ESMA sets out **general principles** an AIFM should comply with when delegating tasks to third parties according to Art. 20. Thereafter, where an AIFM delegates to third parties the task of carrying out on its behalf one or more its functions, the AIFM should comply, in particular, with all of the following conditions:

- a) the delegation should not result in the delegation of senior management's responsibility;
- b) the obligation of the AIFM towards its investors under the Directive should not be altered due to the delegation;
- c) the conditions with which the AIFM must comply in order to be authorized in accordance with the Directive, and to remain so, should not be undermined;
- d) the AIFM should ensure that the delegate carries out the delegated functions effectively and in compliance with applicable laws and regulatory requirements and must establish methods for reviewing the services provided by each delegate on an ongoing basis. The AIFM should 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;
- e) the AIFM should retain the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation. The AIFM should also ensure that the delegate properly supervises the carrying out of the delegated functions, and adequately manages the risks associated with the delegation;
- f) the AIFM should ensure that continuity and quality of the delegated tasks are guaranteed also in case of a termination of delegation by either transferring the delegated tasks to another third party or incorporating it into the AIFM;
- g) the respective rights and obligations of the AIFM and the delegate should be clearly allocated and set out in a written agreement. In particular, the AIFM must contractually ensure its instruction and termination rights. The agreement should make sure that sub-delegation could take place only with the AIFM's consent;
- h) whenever the portfolio management is delegated, the delegation must be in accordance with the investment policy of the AIF. The delegate should be instructed by the AIFM how to implement the investment policy and the AIFM should monitor whether the delegate complies with it on an ongoing basis.

The AIFM should in particular take the necessary steps to ensure that the following conditions are satisfied:

- a) the delegate must disclose to the AIFM any development that may have a material impact on its ability to carry out the delegated functions effectively and in compliance with applicable laws and regulatory requirements;
- b) the delegate must protect any confidential information relating to the AIFM the AIF affected by the delegation and the investors of these AIF;
- c) the delegate must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities while taking into account the types of delegated functions

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### Objective reasons

Art. 20(1)(a) states that the AIFM must be able to justify its entire delegation structure on **objective reasons**. In this respect, ESMA provides for two options:

#### Option 1

The AIFM must be able to justify its entire delegation structure with objective reasons; to comply with this option the AIFM should be able to demonstrate that the delegation is done for the purpose of a more efficient conduct of the AIFM's management of the AIF.

This Option 1 is based on the UCITS approach (Art. 13 UCITS) according to which management companies may delegate tasks "for the purpose of a more efficient conduct of the companies". ESMA considers the UCITS approach as a basis, because many AIFM are already authorized as management companies and because a constant approach with the UCITS Directive avoids the application of different delegation requirements for an AIFM when it on the one hand manages UCITS, and AIF on the other hand. Examples of objective reasons for a more efficient conduct of the AIFM's management of the AIF are cost saving, expertise of the delegate in administration or specific markets / investments or access of the delegate to global trading capabilities.

#### Option 2

Objective reasons for delegating tasks include but are not limited to:

- optimising of business functions and processes;
- cost saving;
- expertise of the delegate in administration / specific markets / investments;
- access of the delegate to global trading capabilities.

This Option 2 provides a non-exhaustive list of objective reasons for delegating tasks instead of providing a high-level-principle.

### Sufficient resources and experience / sufficiently good reputation of the delegate

ESMA proposes that:

1. The AIFM has to evaluate if the delegate has sufficient resources to perform the delegated tasks and if the persons who effectively conduct the business of the delegate are sufficiently experienced and of sufficiently good reputation.
2. The delegate should be considered if the delegate has sufficient resources if it employs sufficient personnel with the skill, knowledge and experience necessary for the discharge of the tasks delegated to it and the appropriate

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### Types of institutions

organizational structure for the delegated tasks.

3. The persons who effectively conduct the business of the delegate should be considered to have sufficient experience if they have appropriate theoretical knowledge and appropriate practical experience in the relevant functions.
4. The persons who effectively conduct the business of the delegate should be considered to have sufficient good reputation if they are at least not subject to any negative records relevant both for the assessment of a good reputation and for the proper performance of the delegated tasks. Such negative records include relevant criminal offences, judicial proceedings or administrative sanctions.

ESMA states that the following **types of institutions should be considered to be authorized or registered for asset management and subject to supervision**:

- management companies authorized under the UCITS Directive;
- investment firms authorized under the MiFID to perform portfolio management;
- credit institutions authorized under the Directive 2006/48/EC having the authorization to perform portfolio management under MiFID; and
- externally-appointed AIFM authorized under the Directive.

Investment companies authorized under the UCITS Directive are not listed above, because they are not allowed to engage in activities other than collective portfolio management (Art. 28 UCITS).

### Preventions of an effective supervision

A delegation would **prevent the effective supervision of the AIFM, or the AIFM from acting, or the AIFM from being managed, in the best interest of its investors** in particular under the following circumstances:

1. A delegation would prevent the effective supervision of the AIFM where the AIFM does not take the necessary steps to ensure that the following conditions are satisfied:
  - (a) the AIFM, its auditors and the relevant competent authorities must have access to data related to the delegated functions, as well as to the business premises of the delegate; and the competent authorities must be able to exercise those rights of access;
  - (b) the delegate must cooperate with the competent authorities of the AIFM in connection with the delegated functions;
  - (c) the AIFM makes available on request to the competent authority all information necessary to enable the authority to supervise the compliance of the performance on the delegated functions with the requirements of Art. 20.
2. A delegation would prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors where the interests of the delegate may conflict with those of the AIFM or the investors of the AIF unless the potential conflicts of interest are properly identified, managed and monitored.

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### Sub-delegations

The conditions set out above should apply **mutatis mutandis** where the delegate sub-delegates any of its functions to a sub-delegate. AIFM should demonstrate its consent to each sub-delegation in writing.

### Delegation resulting in material conflict

Criteria whether a delegation / sub-delegation would result in a **material conflict** of interest with the AIFM or the investors of the AIF:

1. Where the AIFM and the sub-delegate are members of the same group or have any other contractual relationship, it should be taken into account the extent to which the sub-delegate controls the AIFM or has the ability to influence its actions;
2. Where the AIFM is aware that the sub-delegate and the investor of the relevant AIF are members of the same group or have other contractual relationship, it should be considered the extent to which this investor controls the sub-delegate or has the ability to influence its actions.

The portfolio or risk management tasks should be considered as **functionally an hierarchical separated** from other potentially conflicting tasks where the following conditions are satisfied:

1. Those engaged in portfolio management tasks are not engaged in the performance of potentially conflicting tasks such as controlling tasks;
2. Those engaged in risk management tasks are not engaged in the performance of potentially conflicting tasks such as operating tasks;
3. Those engaged in risk management tasks are not supervised by those responsible for the performance of the operating tasks;
4. The separation is ensured up to the governing body of the delegate / sub-delegate.

The functional and hierarchical separation of portfolio or risk management tasks from any other potentially conflicting tasks within the delegate / sub-delegate should be calibrated to the nature, scale and complexity of the delegate / sub-delegate's business and to the nature and range of activities undertaken in the course of that business.

### Potential conflicts

Criteria whether **potential conflicts are properly identified, managed, monitored and disclosed to the investors** of the AIF are the following:

The delegate / sub-delegate should take all reasonable steps to identify, manage and monitor conflicts of interests that may arise between the delegate / sub-delegate and the AIFM or the investors of the AIF. The delegate / sub-delegate should disclose potential conflicts to the AIFM which should disclose them to the investors of the relevant AIF.

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<i>Letter-box entity</i>	<p>The AIFM would become a <b>letter-box entity</b> and could no longer be considered to be the manager of the AIF where:</p> <ol style="list-style-type: none"> <li>1. the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation; or</li> <li>2. 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 implementation of the general investment policy and investment strategies.</li> </ol>
<p><b>Depository (Art. 21)</b></p> <p><i>Mode agreements (Box 74)</i></p> <p><i>Special depositaries for closed-ended funds making illiquid investments and/or acquiring controlling stakes (i.e. private equity and real estate funds)</i></p>	<p>For each AIF it manages, the AIFM shall ensure that a single depository is appointed in accordance with the provisions set forth below. The depository shall generally be a credit institution or an investment firm or similar institutions meeting certain requirements.</p> <p><u><b>LEVEL II PROPOSALS:</b></u></p> <p>ESMA suggests not elaborating a model agreement due to the wide range of different AIFs an AIFM may manage. Instead, ESMA proposes certain requirements on the content of a written agreement evidencing the appointment of a single depository.</p> <p>Member States may allow that for closed ended AIF (no redemption rights exercisable during the period of five years from the date of the initial investments) which, in accordance with their core investment policy, generally do not invest in assets that must be held in custody (i.e. financial instruments) or generally invest in issuers or non-listed companies in order to acquire control over such companies, the depository may be an entity <b>which carries out depository functions as part of its professional or business activities in respect of which such entity is subject to mandatory professional registration recognized by law or to legal or regulatory provisions or rules of professional conduct and which can furnish sufficient financial and professional guarantees to be able to effectively perform the relevant depository functions</b> and meet the commitments inherent to those functions. This is means according to the recitals that a notary, a lawyer or a registrar may assume the depository functions.</p>
<i>Location of depository</i>	<p>The depository shall be located in the home Member State of the EU AIF and for non-EU AIF in the third country where the AIF is established, or in the home Member State of the AIFM managing the AIF, or, as the case may be, in the Member State of reference of the AIFM managing the AIF.</p> <p>The appointment of a depository established in a third country shall at all times be subject to equivalent regulations and certain cooperation and exchange of information arrangements with the competent authorities of the depository.</p>
<i>Functions of depository</i>	<p>The depository must ensure:</p> <ol style="list-style-type: none"> <li>(i) monitoring of cash flows;</li> </ol>



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- (ii) safe-keeping of financial instruments;
- (iii) in case the assets are not financial instruments: verification of ownership (based on documents provided by AIF/AIFM and external evidence, where available);
- (iv) that sale, issue, cancellation of fund shares, units etc. are in accordance with applicable law and fund rules;
- (v) that the value of the shares or units of the AIF is calculated in accordance with the applicable national law and the AIF rules.

The depositary may not delegate to third parties any of its functions, other than the custodian functions relating to financial instruments and even in that case only upon meeting certain requirements.

### LEVEL II PROPOSALS:

Cash monitoring (Boxes 75-77)

#### 1. Cash monitoring

It is ESMA's understanding that the depositary should have a clear overview of all inflows and outflows in all instances. Therefore, the AIFM should ensure that the depositary is, upon commencement of its duties and on an ongoing basis, provided with general information relating to its cash accounts:

- (i) upon the 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;
- (ii) prior to the effective opening of any new cash account by the AIF or the AIFM acting on behalf of the AIF;
- (iii) of cash accounts opened at a third party entity directly from those third parties.

ESMA proposes two options to define the conditions for the depositary to ensure proper monitoring of all AIF's cash flow: either (i) the depositary would be considered as a central hub where all information related to the AIF's cash flow is centralised, recorded and reconciled or (ii) the depositary's obligations would consist in verifying that there are procedures in place to appropriately monitor the AIF's cash flow and that they are effectively implemented and periodically reviewed.

With regard to the conditions for ensuring the AIF's cash is properly booked the depositary should be required to ensure that:

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### Safekeeping

- (i) the AIFM complies on an ongoing basis with the requirements of Art. 16 of Directive 2006/73/EC in relation to cash and in particular where cash accounts are opened at a third party entity in the name of the depositary acting on behalf of the AIF, take the necessary steps to ensure the AIF's cash is booked in one or more cash accounts distinct from the accounts where the cash belonging to the depositary or belonging to the third party are booked;
- (ii) cash accounts have only been opened with entities authorised under Art. 18(1)(a) to (c) of MiFID or any bank or credit institution in the non EU countries in which the AIFM/AIF has been compelled to open a cash account in relation to an investment decision.

### 2. Safekeeping

#### a) Requirements applicable to safekeeping duties

ESMA defines certain safekeeping obligations with respect to financial instruments which can be held in custody. Additionally, ESMA defines certain obligations with respect to financial instruments which cannot be held in custody and all other assets:

- (i) The depositary should ensure it has timely access to all relevant information it needs to perform its ownership verification and record keeping duties, including from third parties (e.g. prime brokers);
- (ii) The depositary should ensure that it possesses sufficient and reliable information for it to be satisfied of the AIF's ownership right or of the ownership right of the AIFM acting on behalf of the AIF over the assets;
- (iii) The depositary should maintain a record of those assets for which it is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership of those assets registering, on behalf of the AIF, assets in its name or in the name of its delegate, or ensuring, where assets are registered directly in the name of the AIF or the AIFM, or physically held by the AIF or the AIFM, it is able to provide at any time a comprehensive and up to date inventory of the AIF's assets. In this context, ESMA proposes two options: the depositary either (i) ensure there are procedures in place so that assets so registered cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions, or have access to documentary evidence of each transaction from the relevant third party on a timely basis, or (ii) mirror all transactions in a position keeping record
- (iv) The depositary should set up and implement an escalation process for situations where an anomaly is detected (e.g. to notify the AIFM and if the situation cannot be clarified / corrected, alert the competent authority).

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*Financial instruments which can be held in custody*

### b) Definition of financial instruments which can be held in custody

ESMA suggests defining financial instruments as transferable securities, money market instrument and units of collective investment undertakings which are not provided as collateral. Additionally, ESMA proposes two alternative options: either (i) the financial instruments should be registered or held in an account directly or (ii) they are financial instruments with respect to which the depositary may itself or through its sub-custodian instruct the transfer of the title or an interest therein by means of book-entry on a register maintained by a settlement system or a similar non-European securities settlement system which acts directly for the issuer or its agent.

In accordance with the above definition of financial instruments, “other assets” pursuant to Art. 21(8)(b) would include but not be limited to:

- (i) physical assets that do not qualify as financial instruments or cannot be physically delivered to the depositary;
- (ii) all financial contracts (e.g. derivative contracts – swaps, options, futures, etc.);
- (iii) all financial instruments, including units and shares of collective investment schemes, issued in a nominative form or registered directly with the issuer or through a registrar acting on behalf of the issuer, in the name of the AIF, provided that they cannot be physically delivered to the depositary;
- (iv) all financial instruments provided as collateral under a title transfer collateral arrangement;
- (v) cash deposits with a third party entity.

*Oversight functions of the depositary (Boxes 82-87)*

### 3. Oversight functions

#### a) General requirements

Upon its appointment the depositary should be required to make an assessment of the most significant risk to be controlled for the specific AIF taking into account various factors. On that basis, the depositary is expected to perform ex post controls and verifications of processes and procedures that are under the responsibility of the AIFM, the AIF or an appointed third party.

#### b) Oversight duties related to subscriptions / redemptions

The Depositary should review the consistency between the number of units or shares issued and the subscription proceeds received. Therefore the depositary should be required to ensure reconciliation is conducted between the

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subscription/redemption orders and the subscription/redemption proceeds. Such reconciliations procedure should be verified by the depositary on a regular basis.

c) Oversight duties related to the valuation of shares or units of the AIF

The AIFM is fully responsible of the valuation process. However, the depositary is expected to ensure that appropriate procedures are in place to perform the NAV calculation and that they are effectively implemented.

d) Oversight duties related to the carrying out of the AIFM's instructions

The depositary should be required to set up and implement the following:

(i) appropriate procedures to verify the compliance of the AIF/AIFM with applicable law and regulation as well as with the AIF's rules and instruments of incorporation, in particular the depositary should monitor compliance of the AIF with investment restrictions and leverage limits defined in the AIF's offering documents

(ii) an escalation procedure where the AIF has breached one of the limits or restrictions referred to the aforementioned.

**ESMA proposes that the depositary would generally be expected to adopt an ex-post approach. However, the provisions laid out in the proposed advice do not prevent the depositary from adopting an ex-ante approach where it deems appropriate, e.g. for AIF which invest in less liquid assets (physical assets, real estate assets) or which initiate less frequent transactions (see Note V.III.1.1. 63).**

e) Oversight duties related to the timely settlement of the transactions

ESMA clarifies what "usual time limits" means outside the scope of transactions executed on a regulated market: the usual time limit should be assessed with regard to the conditions attached to the transactions (OTC derivative contracts, investment in real estate assets or in privately held companies). This duty seems to apply also to Private Equity funds.

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<p><i>Due diligence duties with respect to delegation</i></p> <p><i>Segregation with respect to delegation</i></p>	<p>f) Oversight duties related to the AIF's income distribution</p> <p>The depositary should be required the following:</p> <ul style="list-style-type: none"> <li>• ensure the net income calculation is applied in accordance with the AIF rules, instruments of incorporation and applicable national law;</li> <li>• ensure appropriate measures are taken where the AIF's auditors have expressed reserves on the annual financial statements;</li> <li>• check the completeness and accuracy of dividend payments and where relevant of the carried interest.</li> </ul> <p><b>4. Due diligence duties with respect to delegation</b></p> <p>Pursuant to Art. 21(11), the depositary may delegate its safekeeping function to a third party subject to exercising the selection and the appointment of such third party with due skill, care and diligence.</p> <p><b>5. Segregation</b></p> <p>When delegating safekeeping functions to a third party, the depositary has to verify that the third party has put in place segregation arrangements.</p>
<p><i>Liability of the depositary</i></p> <p><i>Depositary's liability regime (Boxes 90-92)</i></p>	<p>The depositary shall be liable to the AIF, or, as the case may be, to the investors of the AIF, for the loss by the depositary, or as the case may be, a third party to whom the custody has been delegated, of financial instruments held in custody. The depositary shall not be 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.</p> <p>The depositary shall also be liable to the AIF, or, as the case may be, 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 perform its obligations.</p> <p><b><u>LEVEL II PROPOSALS:</u></b></p> <p>ESMA makes proposals for the definition of "loss of financial instruments" (which can be held in custody) and "external events beyond reasonable control" and "objective reason of discharge".</p>

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### Transparency requirements (Art. 22 et seq.)

#### Annual reports

An AIFM shall for each of the EU AIF it manages and for each of the AIF it markets into the EU make available an annual report for each financial year no later than **six months following the end of the financial year**. The annual report shall among others contain the following information:

- (i) Any changes in the information previously disclosed to investors in accordance with the Directive during the financial year (e.g. a description of the investment strategy and objectives of the AIF, the types of assets which the AIF may invest in, of the techniques it may employ and of all associated risks, any applicable investment restrictions, the main legal implications of the contractual relationship, the identity of the AIFM, the depositary, auditor and any other service providers, a description of any delegated management function and of any safekeeping function delegated by the depositary).
- (ii) The total amount of remuneration for the financial year split into fixed and variable remunerations paid by the AIFM to its staff members and the number of beneficiaries and, where relevant, carried interest paid by the AIF, the 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.

#### LEVEL II PROPOSAL:

#### General principles

For the purpose of Art. 22(2)(d) and with reference to Art. 23, ESMA provides a definition for "material change". In accordance with the advice, this term means *"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 for reasons that such information could impact an investors ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors in the AIF"*.

#### General principles for the annual report (Box 102)

For each AIF it markets in the EU, AIFM must make available an annual report in accordance **with Art. 22 (1)**.

The accounting information contained in the annual report **shall be prepared in accordance with the accounting standards applicable in the home Member State of the AIF**, or, as the case may be, **in accordance with the accounting standards of the third country where the AIF is established** and with the accounting rules laid down in the AIF rules or instruments of incorporation.

**Where there is a conflict or dissimilarity between the accounting standards and the accounting rules that may apply to an AIF, the accounting rules shall be followed to the extent that this is permitted by national law.** AIFM shall ensure that the accounting rules adopted provide investors with relevant and timely information with the most appropriate content and in the most appropriate format. **In particular, where applicable accounting standards require consolidation of portfolio companies following an AIF acquiring control of a non-listed company or issuer under Art. 26(1)**, AIFs may be exempted from such requirements where specified in their accounting rules and where permitted under national law.

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*Reporting material changes for the annual report (Box 103)*

The annual report must also material changes in relation to the information to be provided to investors (see hereafter) for the applicable financial year or period.

**‘Material change’** means 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 for reasons that 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 in the AIF.

Such information shall be disclosed in line with the requirements of the accounting standards and rules adopted by the AIF. AIFM shall make additional disclosures when compliance with the specific requirements of the accounting standards and rules may be insufficient to enable investors to understand the impact of the change.

*Content (Boxes 104-105)*

ESMA provides **detailed advice relating to the content and format of the balance sheet (or statement of assets and liabilities) and the content and format of the income and expenditure account.**

It also proposed **advice on content and format of the report on activities for the financial year** pursuant to which the annual report shall contain at least the following elements, Art. 22(2) (c):

- an overview of investment activities during the year or period, and an overview of the AIF’s portfolio at year-end or period end;
- an overview of AIF performance over the year or period; and
- material changes in the information listed in Art. 23 not already presented in the financial statements.

The report shall include a fair and balanced review of the activities and performance of the AIF, containing also a description of the principal risks and investment or economic uncertainties that the AIF may face.

To the extent necessary for an understanding of the AIF’s investment activities or its performance, the analysis shall include both financial and, where applicable according to the AIF type, non-financial key performance indicators relevant to that AIF.

The information provided in the report should be consistent with national rules where the AIF is established.

*Content and format of remuneration disclosure (Box 106)*

Art. 22(2)(e) states: Disclosure within the annual report of the AIF concerned **the total amount of remuneration for the financial year, split into fixed and variable components.**

AIFM shall specify whether the total remuneration disclosed in the AIF’s Annual Report relates to :

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- the total remuneration of the entire staff of the AIFM; or
- the total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF; or
- the proportion of the total remuneration of the staff of the AIFM attributable to the AIF.

**Where this information is disclosed at the level of the AIFM, an allocation or breakdown should be provided in relation to each AIF**, insofar as this information exists or is readily available. As part of this disclosure, the AIFM should include a description of how the allocation or breakdown has been provided.

**In relation to the requirements of Art. 22(2)(f) aggregated amounts broken down by senior management and those members of staff whose professional activities have a material impact on the risk profile of the AIF shall be disclosed unless any such disclosure would breach the requirements of Directive 95/46/EC or other applicable legislation.**

AIFMs shall provide **general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created.**

In accordance with the principles set out in Annex II (Remuneration Policy) of the Directive AIFMs shall disclose at least the information necessary to provide an understanding of the risk profile of the AIF and the measures it adopts to avoid or manage conflicts of interest.

*Disclosure to investors*

An AIFM shall for each of the EU AIF it manages and for each of the AIF it markets in the EU make available to investors the following information **before they invest** in the AIF as well as any changes thereof, including, but not limited to, a description of:

- investment strategy and objectives of the AIF, the types of assets which the AIF may invest in, techniques it may employ and associated risks, any investment restrictions, types and sources of leverage permitted and associated risks, the maximum level of leverage which the AIFM may employ on behalf of the AIF;
- any delegated management functions;
- any conflicts of interest;
- the AIF's valuation procedure and pricing methodology, all fees, charges and expenses and the maximum amounts thereof which are directly and indirectly borne by the investors and
- any preferential treatment.



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### LEVEL II PROPOSAL:

*Disclosures to investors  
(Boxes 107-108)*

Investors should have access to a minimum level of information disclosed by AIFM's for each AIF marketed within the Union or a member state only. The disclosure obligations on AIFMs apply to investors prior to any investment in the AIF(s) concerned and on an ongoing basis.

*Regular disclosure (Box 108)*

Whenever material changes (see above) occur in relation to the elements to be disclosed to investors a disclosure requirement shall be triggered for the AIFM concerned. Such disclosure shall be provided in a clear and timely manner and should contain the following information, as appropriate to the type of AIF:

- the original and revised maximum leverage level;
- the nature of the rights granted for the re-use of collateral;
- the nature of guarantees granted; and
- details of changes in any service providers disclosed

The total amount of leverage employed by an AIFM, on behalf of an AIF, in accordance with the methods of calculation of leverage set out in paragraph 1, shall be disclosed as part of an AIF's periodic reporting to investors as required under the AIF rules or instruments of incorporation, prospectus and offering documents and shall, at a minimum, be disclosed in the AIF's annual report. The disclosure shall include a description of the leverage measures or ratios and their appropriateness when considered against the investment strategy of the AIF, as well as the maximum levels of leverage to which the AIF has been made subject by the AIFM.

*Periodic disclosure (Box 107)*

Periodic disclosure proposed relates among others to the percentage of assets subject to special arrangements (side pockets etc.), risk profile of the AIF and main features of risk management systems employed by the AIFM.

With respect to risk profiles disclosure ESMA proposes two options:

#### Option 1

AIFM shall ensure that periodic disclosures shall contain an assessment of the exposure of the AIF's portfolio **to the most relevant risks to which the AIF is, or could be, exposed, including where risk limits set by the AIFM have been, or are likely to be, exceeded.** Where these risk limits have been exceeded the disclosure should additionally include a description of the circumstances and, where applicable, the remedial measures taken.

#### Option 2

- Periodic disclosure by AIFM shall contain all of the following:
- identification of the most relevant risks to which the AIF is or could be exposed;
- measures used by the AIFM to assess any sensitivity in the AIF portfolio to the most relevant risks to which the AIF is, or could be, exposed; and
- the results of any relevant stress tests, or an indication as to whether, in the opinion of the AIFM, the exposure is likely to increase, is stable or is decreasing and within, near to, or exceeding risk

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	limits set by the AIFM. Where risk limits have been exceeded the disclosure shall additionally include a description of the circumstances and, where applicable, the remedial measures taken.
Reporting obligations to competent authorities	<p>The AIFM shall for each of the AIF it manages and markets in the EU provide the same information as disclosed to investors to the competent authorities of its home Member State. It shall make available information about the overall level of leverage employed by each AIF it manages. That information shall also include the identity of the five largest sources of borrowed cash or securities for each of the AIF managed by the AIFM and the amounts of leverage received from each of those entities for each of the AIF managed by the AIFM.</p>
Reporting to competent authorities	<p><b><u>LEVEL II PROPOSAL:</u></b></p> <p>The AIFM Directive requires AIFM of all types to provide certain information on a regular basis to the competent authority of the home Member State for each EU AIFM they manage and for each of the AIF they market in the Union. In this context, ESMA provides for rules concerning the format and content of reporting to competent authorities.</p> <p>In order to comply with the requirements in Art. 24(4) an AIFM employing leverage shall make an assessment for each EU AIF it manages and for each of the AIF it markets in the Union as to whether leverage is being employed on a substantial basis in accordance with the methods of calculation of exposure of AIF (see page 43).</p> <p>The assessment of whether leverage is employed on a substantial basis shall have regard to the following non exhaustive considerations:</p> <ul style="list-style-type: none"> <li>(a) the type of AIF under management including its nature, scale and complexity;</li> <li>(b) the investment strategy of the AIFM in relation to the AIF concerned;</li> <li>(c) the market conditions in which the AIF and the AIFM operate;</li> <li>(d) whether the exposures of an AIF arising through the use of leverage by an AIFM could constitute an important source of market risk, liquidity risk or counterparty risk to a credit institution or other systematically relevant institution;</li> <li>(e) whether the techniques employed by the AIFM through use of leverage could contribute to the aggravation or downward spiral in the prices of financial instruments or other assets in a manner which threatens the viability of these prices; and</li> <li>(f) whether the degree of leverage employed by an AIF could contribute to the build up of systemic risk in the financial system or risk of disorderly markets</li> </ul> <p>The AIFM shall monitor, on an ongoing basis, their use of leverage and, where there is a material change shall carry out a new assessment.</p>

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*Special disclosure obligations for AIFM managing leveraged AIFs (Art. 25 et seq.)*

The AIFM must demonstrate to the competent authority that the leverage limits for each AIF it manages are reasonable and that it complies at all times with the leverage limits set by it. Competent authorities shall assess the risks that the use of leverage by AIFM with respect to specific AIFs could entail and when it is deemed necessary in order to ensure the stability and integrity of the financial system, the competent authorities shall impose limits to the level of leverage that an AIFM may employ or other restrictions on the management of the AIFM with respect to the AIF under its management. Similarly, the new European authorities ESMA or ESRB may, based on the information received by the competent (national) authorities, determine that the leverage employed by an AIFM or by a group of AIFM poses substantial risk and may issue advice to competent authorities specifying the remedial measures to be taken (including limits to the level of leverage).

### Leverage

*Methods for calculating the exposure of an AIF*

#### LEVEL II PROPOSALS:

Regarding the calculation of the exposure ESMA clarifies that no one single method can be applied to the wide range of AIF that are within the scope of the Directive. Therefore, ESMA has set out two mandatory methods of calculation the AIF's exposure (the Gross Method; the Commitment Method considers netting and hedging relationship) and an additional method that may be used by an AIFM which is required to notify the competent authorities of its home Member State pursuant to Art. 25(3) (Advanced Method).

ESMA clarifies that AIFM, when calculating exposure, should “**look through**” corporate structures to the extent that **those structures have recourse to the AIF via cross-collateralisation or guarantees.**

*Methods of increasing the exposure of an AIF*

When calculating exposure, ESMA proposes that AIFMs should take into account certain non-exhaustive methods (e.g. cash borrows, swaps, futures, repurchase agreements etc.).

*Exposures involving third party legal structures*

With respect to recital 78 of the Directive (“...any financial and/or legal structures involving third parties controlled by the relevant AIF, where the structures referred to are structures specifically set up to directly or **indirectly create leverage at the level of the AIF**. In particular for private equity and venture capital funds this means that, leverage that exists at the level of a portfolio company is not intended to be included when referring to such financial or legal structures.”) ESMA proposes three options to assist firms when interpreting these requirements.

#### Option 1

AIFMs shall include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that entities involved within those structures **have recourse to the AIF via cross-collateralisation or guarantees, including guarantees, where there is an expectation that the AIF will contribute to the underlying structure even through there is no legally enforceable obligation.**

#### Option 2

AIFMs shall include in the calculation of leverage any exposure which is contained within financial and/or legal structures

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<p><i>Limits to leverage or other restrictions on the management of AIF (Box 100)</i></p>	<p>involving third parties to the extent that <b>entities involved within those structures are non-listed companies or issuers controlled by the AIFM within the scope of Art. 26 and have recourse to the AIF via cross-collateralisation or guarantees, including guarantees, where there is an expectation that the AIF will contribute to the underlying structure even though there is no legally enforceable obligation.</b></p> <p>Option 3</p> <p>AIFMs shall not include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that the AIF is holding ordinary shares, shares in a target company or shares or units in a collective investment undertaking as an investment and the capital of the AIF that is at risk through this position is limited to the market value of those shares or units. However, AIFMs shall include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to <b>the extent that the AIF has provided guarantees for any shortfall in the value of the property relating to the underlying shares or units have been secured or where a loan has been secured on property relating to the underlying shares or units outside of a portfolio company structure by way of cross-collateralisation.</b></p> <p>ESMA proposes to define certain circumstances and criteria when the competent authority should undertake an assessment to ensure the stability and integrity of the financial system.</p>
<p><b>Special obligations for AIFM managing AIFs which acquire major holdings or control of non-listed companies and issuers (private equity) (Art. 26 et seq.)</b></p>	<p>The Directive provides for a set of rules establishing certain disclosure obligations for AIFM managing AIF which acquire major holding or control of non-listed companies and issuers (private equity funds).</p>

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<i>Scope of the specific "private equity" disclosure requirements</i>	<p>Special disclosure requirements shall apply to (i) AIFM managing one or more AIF which either individually or jointly, acquire major holding or control of a portfolio company and to (ii) AIFM cooperating with one or more other AIFM on the basis of an agreement pursuant to which the AIF managed by these AIFM jointly, acquire major holding control of a portfolio company.</p> <p>For the purpose of this section, "control" shall mean with respect to non-listed companies more than 50% of the voting rights of the company. When calculating the percentage of voting rights held by the relevant AIF, not only the voting rights held directly by the relevant AIF shall be taken into account, but also the voting rights of (i) any undertaking controlled by the AIF and (ii) those of any natural or legal person acting in its own name but on behalf of the AIF or of any undertaking controlled by the AIF.</p> <p>The special disclosure (and asset stripping) requirements shall not apply where the non-listed companies concerned are small and medium enterprises within the meaning of Art. 2(1) of the annex of Commission Recommendation 2003/361/EC concerning the definition of micro, small and medium sized enterprises ("SME") or real estate special purpose vehicles. SME are 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.</p> <p>The special disclosure requirements are subject to the restrictions of the protection of confidential information (Art. 6 of Directive 2002/14/EC).</p>
<i>Notification upon exceeding certain thresholds</i>	<p>When an AIF acquires, disposes or holds shares of a non-listed company, the AIFM managing this AIF must notify the competent authorities of its home Member State 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%.</p> <p>The notifications shall be made as soon as possible, but not later than ten working days upon the event of exceeding an participation threshold or acquisition of control over a non-listed company.</p>
<i>Disclosure of control (Art. 28)</i>	<p>When an AIF, individually or jointly, acquires control over a non-listed company (or an issue as described above), the AIFM managing such AIF shall notify:</p> <ul style="list-style-type: none"> <li>(i) the non-listed company,</li> <li>(ii) 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 get access, and</li> <li>(iii) the competent authorities of the home Member State of the AIFM.</li> </ul> <p>And such notification must contain additional information such as:</p> <ul style="list-style-type: none"> <li>(i) the resulting situation in terms of voting rights;</li> <li>(ii) the conditions under which control has been reached (e.g. including information about the identity of the different shareholders involved);</li> </ul>

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	<p>(iii) the date on which control was reached;</p> <p>(iv) the identity of the AIFM which either individually or in agreement with other AIFM manage(s) the AIF that has/have reached control;</p> <p>(v) the policy for preventing and managing conflicts of interests (in particular between the AIFM, the AIF and the company) and</p> <p>(vi) the policy for external and internal communication relating to the company in particular as regards employees.</p> <p>In its notification to the company, the AIFM shall <b>request the board of</b> directors of the company to <b>inform the representatives of employees</b> or, where there are no such representatives, the employees themselves, without undue delay of the information referred to above. The AIFM shall use its best efforts to ensure that the board of directors informs the employees in accordance with what is set forth above</p> <p>When an AIF acquires, individually or jointly, control of a non-listed company, the AIFM managing such AIF shall ensure that the AIF, or the AIFM acting on behalf of the AIF, makes available its <b>intentions with regard to the future business</b> of the non-listed company and the <b>likely repercussions</b> on employment, including any material change in the conditions of employment, to (i) the non-listed company, and (ii) the shareholders of the non-listed company of which the identities and addresses are available to the AIFM or can be made available.</p> <p>When an AIF reaches a position to exercise control of a non-listed company, the AIFM shall further provide the competent authorities of its home Member State and the investors of the AIF with information on the financing of the acquisition.</p>
<i>Annual reporting of AIF exercising control of non-listed companies (Art. 29)</i>	<p>When an AIF acquires, individually or jointly, control of a non-listed company, the AIFM managing such AIF shall</p> <p>(i) either request and use its best efforts to make sure that the annual report of the non-listed company is drawn up in accordance with the Directive and made available by the board of the company to all representatives of employees or, where there are no such representatives, to the employees themselves within the period such annual report has to be drawn up in accordance with the national applicable law; or</p> <p>(ii) for each such AIF include in the annual report of the AIF the information relating to the relevant non-listed company referred to in Art. 29(2).</p> <p>Such additional information to be included in the annual report of the company, or, as the case may be, the AIF includes:</p> <p>(i) 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;</p> <p>(ii) an indication of:</p> <ul style="list-style-type: none"> <li>any important events that have occurred since the end of the financial year;</li> </ul>

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- the company's likely future development;
- the information concerning acquisitions of own shares prescribed by Art. 22(2) of Directive 77/91/EEC.

### *Asset stripping (Art. 30)*

When an AIF, individually or jointly, acquires control of a non-listed company, the AIFM managing such AIF is before the end of **the period expiring 24 months following the acquisition of control** of the company by the AIF not allowed to facilitate, support, instruct or, if applicable, to vote on behalf of the AIF at the governing bodies of the company in favour of any distribution, capital reduction, share redemption and/or acquisition of own shares by the company as described below and in any event use its best efforts to prevent distributions, capital reductions, share redemptions and/or the acquisition of own shares.

The above mentioned obligations of the AIFM shall relate to the following:

- any distribution 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 be not distributed under the law or the statutes;
- any distribution 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;
- 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 subparagraph (i).

The expression "**distribution**" shall include in particular the payment of dividends and of interest relating to shares.

The provisions on capital reductions do not apply on a reduction in the subscribed capital whose purpose it is to offset losses incurred or to include sums of money in a non-distributable reserve provided that, following this operation, the amount of such reserve is not more than 10% of the reduced subscribed capital.

The restriction in subparagraph (iii) shall be subject to the exceptions and conditions laid down in Art. 20(1)(b) to (h) of the Second Company Law Directive 77/91/EEC. Under these provisions certain transactions that would otherwise constitute an acquisition of own shares are not treated as such (e.g. shares acquired as a result of a universal transfer of assets, fully paid-up shares acquired free of charge or shares acquired from a shareholder in the event of failure to pay them up).