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Directive on Alternative Investment Fund Managers (AIFMs) : Frequently Asked Questions

(see [IP/09/669](#))

Since the proposed Directive has been submitted to the Council and the European Parliament for consideration under the co-decision procedure, the answers to these questions cannot be regarded as definitive.

Furthermore, the information which is provided here is:

- of a general nature only and is not intended to address the specific circumstances of any particular individual or entity;
- is not necessarily complete and does not systematically cover all the aspects of the proposal;
- is made available for general information only and does not constitute professional or legal advice;
- in no way constitutes an interpretative document.

It does not prejudice the position that the Commission might decide to take on the same matters if developments, including Court rulings, were to lead it to revise some of the views expressed here.

Nor does it prejudice the interpretation that the Court of Justice of the European Communities might place on the matters covered.

What are the key objectives of the proposal?

The Directive will introduce harmonised comprehensive and effective regulatory and supervisory framework for Alternative Investment Fund Managers (AIFM) in the EU. For the purposes of the Directive, AIF are defined as all funds that are at present not harmonised under the UCITS Directive. The AIF sector in the EU is relatively large - the AIFM managed around €2 trillion in assets at the end of 2008 - and diverse. hedge funds, private equity funds, commodity funds, real estate funds and infrastructure funds, among others, fall within this category.

The specific objectives of the AIFM Directive are to:

- Ensure that all AIFM are subject to appropriate authorisation and registration requirements;
- Provide a framework for the enhanced monitoring of macro-prudential risks, e.g. through sharing of relevant data among supervisor;
- Improve risk management and organisational safeguards to mitigate micro-prudential risks;
- Enhance investor protection;
- Improve public accountability for AIF holding controlling stakes in companies;
- Develop the single market for AIFM.

What risks is the proposal tackling?

The financial crisis has underlined the extent to which AIFM are vulnerable to a wide range of risks. These risks are of direct concern to the investors in those funds, but also present a threat to creditors, trading counterparties and to the stability and integrity of European financial markets.

The nature and intensity of these risks varies between the different business models that AIFM pursue. For example, macro-prudential risks associated with the use of leverage relate primarily to the activities of hedge funds and commodity funds managers; whereas risks associated with the governance of portfolio companies are most closely associated with private equity. However, other risks, such as those relating to the management of micro-prudential risks (in particular to the internal risk management systems of the AIFM) and to investor protection are common to all types of AIFM. The risks associated with their activities have manifested themselves throughout the AIFM industry over recent months and may in some cases have contributed to market turbulence.

Given the global nature of their activities, many risks posed by AIFM have an important cross-border dimension. The impact of risks crystallising in the AIFM sector in one Member State will therefore be felt beyond national borders.

Were AIFM at the origin of the financial crisis? What impact did this crisis have on them?

While AIFM were not the cause of the crisis, recent events have placed severe stress on the sector. The risks associated with their activities have manifested themselves throughout the AIFM industry over recent months and may in some cases have contributed to market turbulence. For example, hedge funds have contributed to asset price inflation and the rapid growth of structured credit markets. The abrupt unwinding of large, leveraged positions in response to tightening credit conditions and investor redemption requests has had a procyclical impact on declining markets and may have impaired market liquidity.

Funds of hedge funds have faced serious liquidity problems: they could not liquidate assets quickly enough to meet investor demands to withdraw cash, leading some funds of hedge funds to suspend or otherwise limit redemptions.

Private equity funds due to their investment strategies and a different use of leverage than hedge funds, did not contribute to increase macro-prudential risks. They have experienced challenges relating to the availability of credit and the financial health of their portfolio companies. The inability to obtain leverage has significantly reduced buy-out activity and a number of portfolio companies previously subject to leveraged buy-outs are reported to be faced with difficulties in finding replacement finance. Commodity funds were implicated in the commodity price bubbles that developed in late 2007.

Are not AIFM already regulated at national level?

Currently, the activities of AIFM are regulated by a combination of national financial and company law regulations and general provisions of Community law. They are supplemented in some areas by industry-developed standards. However, recent events have indicated that some of the risks associated with AIFM have been underestimated and are not sufficiently addressed by current rules. This is partly a reflection of the predominantly national perspective of existing rules: the regulatory environment does not adequately reflect the cross-border nature of the risks.

Nationally fragmented approaches do not constitute a robust and comprehensive response to risks in this sector. Effective management of the cross-border dimension of these risks demands a common understanding of the obligations of AIFM; a coordinated approach to the oversight of risk management processes, internal governance and transparency; and clear arrangements to support supervisors in managing these risks, both at domestic level and through effective supervisory cooperation and information sharing at European level.

What are the key provisions of the AIFM Directive? How will the Directive work?

All EU domiciled AIFM with assets under management above the threshold of 100 million EUR or, in case of AIF with no leverage and lock-in period of 5 years or more, above the threshold of 500 million EUR will need to be authorized by the home Member State competent authority (CA) and subject to ongoing requirements.

All AIFM operating in the EU will be required to demonstrate that they are suitably qualified to provide AIF management services and will be required to provide detailed information on the planned activity of the AIFM, the identity and characteristics of the AIF managed, the governance of the AIFM (including arrangements for the delegation of management services), internal arrangements with respect to risk management, arrangements for the valuation and safe-keeping of assets, audit arrangements, and the systems of regulatory reporting, where required. The AIFM will also be required to hold and retain a minimum level of capital.

AIFM will be required to report to the CA on a regular basis on the principal markets and instruments in which it trades, its principal exposures, performance data and concentrations of risk. The AIFM will also be required to notify the CA of the home Member State of the identity of the AIF managed, the markets and assets in which the AIF will invest and the organisational and risk management arrangements established in relation to that AIF. Additional disclosure obligations will apply to AIFM managing leveraged AIF and controlling stakes in companies.

AIFM authorised in its home Member State will be entitled to market its funds to professional investors in any Member State. The cross-border marketing of AIF would be subject to a notification procedure, under which relevant information is provided to the home Member State and transmitted to the host. AIFM shall also be entitled to freely provide management services in Member States other than their Member State of domicile, subject to a notification procedure.

Why the AIFM Directive does not focus only on hedge funds and private equity?

While the public discussion is currently focused on hedge funds and private equity, the European Commission believes that it would be ineffective and short-sighted to limit any legislative initiative to these two categories of AIFM: ineffective because any arbitrary definition of these funds might not adequately capture all the relevant actors and could be easily circumvented; and short-sighted because many of the underlying risks are also present in other types of AIFM activity. The response which is likely to prove the most enduring and productive is therefore to capture all AIFM whose activities give rise to those risks. Accordingly, the management and administration of any non-UCITS in the European Union must be authorised and supervised in accordance with the requirements of the Directive.

This broad coverage does not imply a 'one size fits all' approach. A common set of basic provisions will govern the conditions for the initial authorisation and organisation of all AIFM. These core provisions will be tailored to the different types of AIFM so that irrelevant or inappropriate requirements are not imposed on investment policies for which they make no sense. In addition to these common provisions, the proposal foresees a number of specific, tailored provisions which will only apply to AIFM that employ certain techniques or strategies when managing their AIF (for instance, systematic use of a high degree of leverage, acquisition of control of companies) and will ensure an appropriate degree of transparency with respect to these techniques.

Why the AIFM Directive regulates fund managers instead of funds?

The Directive is focused on regulating the activities of AIFM, since it is the AIFM who is responsible for all key decisions in relation to the management of the fund. Financial stability and investor risks stem primarily from the conduct and organisation of the manager and the providers of key services, notably the depositary and valuation agents. The most effective response is therefore to focus on these entities.

The proposal does not impose registration requirements directly on funds, nor does it regulate investment policies. Regulation of investment policies would be unnecessarily restrictive given the professional nature of the investor base and would be impractical to implement given the diversity of business models. The proposal nevertheless has a strong indirect impact on the way that funds are managed and ensures that authorities are fully informed about the funds marketed in their jurisdiction through disclosure obligations on managers.

There is therefore no obvious regulatory need for regulating investment policies directly or for requiring the registration of funds. In the absence of direct fund regulation and in the context of robust regulation of the main risk centres, the benefits of fund registration would likely be outweighed by the additional burden on funds and regulators. Moreover, the introduction of a fund registration system could be a source of moral hazard. Investors may perceive that regulators exercise greater direct control over the fund than is in fact the case. This may result in investors foregoing the necessary due diligence and exposing themselves to greater risks.

How does the proposal treat AIFM/AIF established in third countries? Will they continue to be able to do business in Europe?

The Directive provides that only AIFM established in Europe can provide their services in the Community. In the same way, only funds domiciled in Europe can be marketed by EU authorized AIFM on the European territory.

However, the Directive recognises that the management of offshore funds is an important feature of the hedge fund and private equity business models. The proposal will provide a safe and secure framework for it to continue. It will provide an "EU passport" for the marketing of those third country funds which comply with stringent requirements on regulation, supervision and cooperation, including on tax matters. However more time will be needed to do the necessary preparation and groundwork to make this a success. Therefore the rules allowing the marketing of third country funds will come into force 3 years after the rest of the Directive. In the meantime third country funds will continue to be sold in those Member States which currently allow that. This will be a strong incentive in the years ahead for the jurisdictions and managers concerned to deliver the necessary improvements in supervision, cooperation with European supervisors and compliance with the OECD Tax code. This approach is consistent with the objectives of the G20 to enhance the transparency and the quality of regulation in offshore financial centres.

What rights will AIFM enjoy once authorized?

Authorisation as an AIFM will entitle the manager to market the AIF to professional investors only (as defined by MiFID). Many AIF entail a relatively high level of risk (of loss of much or all of the capital invested) and/or have other features which render them unsuitable for retail investors. In particular, they may lock investors in to their investment for longer than is acceptable for retail funds. Investment strategies are typically complex and often involve investment in illiquid and harder-to-value investments. The marketing of these AIF will therefore be limited to those investors that are equipped to understand and to bear the risks associated with this type of investment.

The limitation to professional investors is consistent with the current situation in many Member States. However, some of the categories of AIF covered by the proposed Directive – such as funds of hedge funds and open-ended real estate funds - are accessible to retail investors in some Member States, subject to strict regulatory controls. Member States may allow for marketing to retail investors within their territory and may apply additional regulatory safeguards for this purpose. In no case, will a Member State be obliged to accept the marketing on its territory of funds authorized for the marketing to retail investors in other Member States as there will be no passporting rights in this area.

Compliance with the requirements of the proposed Directive would be sufficient to permit AIFM to market AIF to professional investors on markets in other Member States. The competent authority of host Member States will have access to appropriate information before AIFM can start its cross-border marketing activity.

Why does the Commission focus on big AIFM and exempts large number of small AIFM?

AIFM managing AIF portfolios with total assets of less than the following thresholds will be exempt from the provisions of the proposed Directive: (i) €100 million EUR (including any assets acquired through the use of leverage) or (ii) €500 million EUR when the portfolio of AIF consists of AIF that are not leveraged and with no redemption rights exercisable during a period of 5 years following the date of constitution of each AIF.

A threshold of €100 million implies that roughly 30% of hedge fund managers, managing almost 90% of assets of EU domiciled hedge funds, would be covered by the Directive. It would capture almost half of managers of other non-UCITS funds and provide an almost full coverage of the assets invested in their funds. The threshold allows supervisory attention to be focused on the areas where risks are concentrated. A €100m threshold also ensures that most managers in niche businesses for whom the new requirements could be overly burdensome would not be caught by the Directive. The second threshold of €500 million combined with two conditions will ensure that AIFM that do not pose systemic risks or direct risks to financial stability such as start-up and venture capital do not have to comply with the requirements.

The administrative burden resulting from the application of the Directive to all AIFM would not be proportionate for both smaller AIFM and supervisors. It would not contribute significantly to the main objectives of the Directive (improved macro-prudential oversight, investor protection, and internal market integration). Smaller AIFM in themselves do not pose systemic or market risks. The likelihood that a number of smaller AIFM follow identical or at least very similar strategies and thereby affect international markets adversely can be regarded as relatively minor.

Smaller AIFM are usually more focussed on the local market. Therefore, it is also appropriate that they remain under national regulation and supervision instead of being covered by EU level regulation. This is also in the interest of investor protection which should be as close to the investor and its specific context. Cross-border supervision would be of lower importance. If smaller funds should be interested in cross-border business the rights granted by the Directive would provide a strong incentive for them to opt-in and to comply with its obligations.

Will AIF need to comply with capital requirements similarly to banks?

As regards capital requirements for AIFM, the proposals provides for a minimum capital requirements to ensure the continuity and regularity of the AIFM services. It is a standard practice to oblige fund managers to retain capital for investor protection reasons. It shall enable investors to claim damages in case of fraud or other wrongdoing by the manager. This risk is however rather low, given that the fund's assets are segregated from the AIFM and safe-kept by the depositary which also books the investor's money on a segregated account. The minimum capital for AIFM is EUR 125.000, but additional capital is required if the assets under management exceed EUR 250 million.

The draft proposal does not provide for any capital requirements for the fund. The rationale for capital retentions for banks does not extend to AIFM. Investors which e.g. invest in hedge funds knowingly seek exposure to (relatively) high risks with the aim of (potential) high profits. There is no guarantee that investors will get paid back the invested money (plus profits). Bank saving, by contrast, works on the principle that deposits and interest payments are safe.

Furthermore, leverage of hedge funds is on average much lower than leverage of investment banks. While the latter use leverage ratios of up to a factor of 30 or even 50 in some cases, leverage ratio of hedge funds is down from a factor of 2 before the crisis to factor 1 in 2008, i.e. the average leverage used by hedge funds equals their net assets. These figures illustrate that the systemic risk posed by the use of leverage by hedge funds is significantly lower than that of investment banks.

The possible impact of the failure of an individual hedge fund on the banking sector is currently addressed through the prudential regulation of prime brokers. Prime brokers are required to hold capital against their hedge fund exposures and to have in place robust counterparty risk management systems. The reform of European banking regulation is part of the comprehensive package of reforms announced in the Commission Communication on Driving European Recovery¹. The Basel Committee has recently started a comprehensive review of the Basel II prudential treatment for counterparty credit risk (posed by e.g. hedge funds) and the relevant disclosure provisions.

In addition, the proposed Directive however obliges AIFM to employ a liquidity risk management system. This system shall ensure that the fund may satisfy requests by investors wishing to withdraw money. This notably requires the AIFM to prevent a mismatch between the frequency of investor redemptions and the illiquid nature of the portfolio (i.e. the less liquid the assets are, the less frequent investors may redeem

¹ Commission Communication COM(2009) 114 of 4 March 2009

Will the proposal address the issues of short-selling and remuneration?

This proposal focuses on those activities that are specific or inherent to the AIFM sector and hence need to be addressed by targeted requirements. A number of the concerns that are commonly expressed about the activities of AIFM are linked to behaviours (e.g. short-selling, and remuneration) which are not unique to this category of financial market participants. To be fully effective and coherent, these concerns must therefore be addressed by comprehensive measures which apply to all market participants who engage in the relevant activities. The discriminatory treatment of particular market actors would create distortions and would not respond in a comprehensive manner to the risks posed.

Short-selling and its associated impacts on market efficiency and integrity are not the exclusive preserve of the AIFM sector. To the extent that stricter regulatory controls and/or greater transparency is required in this area, actions would be better targeted at all market practitioners. The Commission is considering these issues as part of the ongoing reviews of the existing acquis (eg. Consultation paper on Market Abuse Directive review which will focus on abusive short selling). Nonetheless, the AIFM Directive however includes provisions regarding AIFM risk management and transparency requirements when they engage in short-selling activities.

The **Recommendation on Remuneration** in the financial services sector will apply to AIFM (having its registered office or head office in the EU). Recommendation would apply to all staff of the companies having an impact on the risk profile of the financial institution. The fees that AIFM charge for the management service to the AIF are outside the scope of the draft Recommendation as these issues concern relations with customers and are partially covered by other regimes (such as MiFID) or are currently discussed in other fora (remuneration of credit intermediaries). Directors of AIF are covered and to the extent that the funds are listed the more detailed **Recommendation on directors' remuneration** will also apply.

Will the proposal improve investor protection? In what way?

Investor protection is one of the objectives of the proposed Directive. The proposal will allow for appropriate protection of professional investors mainly through the increased transparency of the AIFM and funds it manages and markets on an initial and ongoing basis to facilitate their due diligence.

In particular, the proposed Directive requires AIFM to disclose to AIF investors risk, return and liquidity characteristics of AIF, identity of the AIF's service providers (i.e. depository, valuator, auditor), and the AIFM's risk management systems. For each AIF an AIFM manages, it shall periodically disclose to investors the percentage of the AIF's assets which are subject to special arrangements (e.g. side pockets) arising from their illiquid nature. AIFM will be also required to describe all fees and charges which are directly or indirectly borne by investors as well as preferential treatment provided to other investors by AIFM.

How will AIFM be supervised, in particular when engaging in cross-border business?

In order to ensure the secure functioning of the AIFM sector, competent authorities of the Member States will be required to cooperate whenever necessary so as to achieve the aims of the Directive.

AIFM will have extensive reporting obligations to competent authorities of its home Member State. Given the cross-border nature of risks arising in the AIFM sector, a prerequisite for effective macro-prudential oversight will be the timely sharing of relevant macro-prudential data at the European, or even global, level. The competent authorities of the home Member State will thus be required to transmit relevant macro-prudential data, in a suitably aggregated format, to public authorities in other Member States and to CESR.

Aggregated information relating to the activities of AIFM under its responsibility shall be communicated on a quarterly basis by the competent authority of the AIFM to the Economic and Financial Committee established by Article 114(2) of the EC Treaty.

The competent authorities of one Member State may request the co-operation of the competent authorities of another Member State in a supervisory activity or for an on-the-spot verification or in an investigation on the territory of the latter within the framework of their powers pursuant to this Directive.

Is not the regulation of AIFM a global issue? Should this proposal be better taken at international level?

This proposal complies with the political commitments made by G20 to ensure that *'all relevant actors ... are subject to appropriate regulation and oversight'* as well as the Commission Communication of 4 March 2009. These commitments need to be translated into concrete legal action. Currently, no international body beyond the EU has the power to adopt such binding measure. With this proposal the Commission will give effect to principles set out by G20 in April and which reflect a global consensus for a tighter regulation of the alternative investment fund sector.

The Commission proposal is the first of its kind in the world, trying to tackle in a proportionate way risks and vulnerabilities stemming from activities of the alternative investment fund managers. There are signs that in particular the US authorities may be moving towards a similar regulatory oversight although no concrete proposal has been tabled yet. Regardless, the Commission feels it is in a right position to act now and to tackle issues needed for the benefit of the European markets and investors.

How did the commission consult the stakeholders when preparing its proposal?/ Has the Commission carried out an impact assessment of its proposal?

The Directive builds on an extensive consultation and on the numerous insights and research that the Commission has gathered in recent years through studies and impact assessments on the functioning of the non-harmonized investment fund segment. The latest round of consultations took place in February 2009 and concerned the activities of hedge funds.

Major steps	Timing
Expert groups on alternative investments	January - July 2006
Public consultation on expert group reports	July - October 2006
White Paper on investment funds	November 2006
Comparative study on investment powers	December 2006 - January 2008
Study on the retail distribution of non-harmonised funds	December 2007 – September 2008
Expert group on open ended real estate funds	July 2007 – February 2008
Open consultation on the report of the expert group	March – June 2008
Call for evidence on private placement	April – June 2007
Workshops on private placement	January – February 2008
Open hearing on non-harmonised retail funds	8 April 2008
Impact assessment on private placement	July 2008
Consultation on hedge funds	December 2008 – January 2009
Impact assessment on retail-oriented non-harmonised investment funds	January 2009
Conference on hedge funds and private equity	26-27 February 2009
Impact assessment on alternative investment fund managers	March 2009

How will the AIFM regulatory framework be implemented? Is the new AIFM Directive a 'Lamfalussy' Directive? Will additional implementing measures be based upon it?

Yes, the provisions of the AIFM Directive are principles-based and will be complemented by implementing measures adopted by the European Commission. The use of the 'Lamfalussy approach' will allow for the broad regulatory framework to be established at Level 1, followed by the development of more detailed implementing legislation at Level 2. Implementing measures will deal with the more technical requirements and will be prepared on the basis of advice provided by CESR. The choice of a Directive would also allow Member States flexibility in incorporating provisions into national law.

The Commission considers that this is the most efficient approach to ensure that the new rules benefit from the input and experience of the national supervisors. It will also allow for regular update of these technical requirements as they will not have to be adopted through the co-decision procedure (adoption by the European Parliament and Council).

For example, the Directive sets some general principles as regards the rules Member States should impose on AIFM in the area of liquidity management. In the same time, the Commission receives powers to adopt more detailed rules to specify these liquidity requirements.

When will the new AIFM Directive be in force?

The Commission has tabled a sound proposal which can serve as a good starting point for negotiations on the sound EU legislative framework for AFIM. This proposal will now be sent to the European Parliament and European Council where it is expected to be the object of intense political discussion and negotiation in view of the emblematic subject matter. If a political approval on the Commission's proposal is reached by the end of 2009, the Directive could come into force in 2011. As an exception, the provisions regarding the treatment of third countries will only become applicable in 2014, after a period of transition of three years.