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## Directive on Alternative Investment Fund Managers ('AIFMD'): Frequently Asked Questions<sup>1</sup>

### What is an Alternative Investment Fund Manager ('AIFM')?

An AIFM is a manager of an alternative investment fund. The term alternative investment fund encompasses a wide range of investment funds that are not already regulated at European level by the UCITS Directive ([IP/10/869](#)). They include hedge funds, private equity funds, real estate funds and a wide range of other types of institutional fund. The AIFMD is therefore much more than a 'hedge fund directive'.

The AIFMD will not apply to entities such as governments managing funds supporting social security and pension systems; supranational institutions, such as the World Bank and member organisations of the World Bank Group; and other entities expressly excluded from its scope.

### 2. Why do we need the AIFMD? What is the link with the financial crisis?

A secure and stable financial system requires that all significant financial market actors are subject to appropriate regulation and supervision. This was a clear conclusion of the G20 leaders.

AIFM have grown to become very significant actors in the European financial system, managing a large quantity of assets on behalf of pension funds and other investors; accounting for a significant proportion of trading activity in financial markets; and constituting an important source of counterparty risk for other market participants. AIFM have also contributed to the build-up of leverage in the financial system, the consequences of which for the stability of financial markets became apparent when leverage in the hedge fund sector was rapidly unwound during the crisis.

In this context, it is essential that the risks that AIFM pose to their investors, the financial markets and the companies in which they invest are rigorously monitored and controlled. The crisis exposed a number of deficiencies in this regard, notably a lack of transparency, deficiencies in risk management and asset-safekeeping arrangements, and weaknesses in due diligence.

By responding to these risks, the AIFMD is therefore a key part of the European Commission's drive to lay the regulatory foundations for a secure financial system that supports and stimulates the real economy.

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<sup>1</sup> This is a working document of the Commission services and is intended for information purposes only. It does not purport to reflect the views of the College of Commissioners on matters of interpretation of this Directive; and is without prejudice to subsequent rulings of the European Court of Justice in this regard.

## **What are the objectives of the AIFMD?**

The overarching objective of the AIFMD is to create, for the first time, a comprehensive and secure framework for the supervision and prudential oversight of AIFM in the EU. Once the AIFMD enters into force, all AIFM will be required to obtain authorisation and will be subject to ongoing regulation and supervision. In this way, the AIFMD will:

- Increase the transparency of AIFM towards investors, supervisors and the employees of the companies in which they invest;
- Equip national supervisors, the European Securities Markets Agency ('ESMA') and the European Systemic Risk Board ('ESRB') with the information and tools necessary to monitor and respond to risks to the stability of the financial system that could be caused or amplified by AIFM activity;
- Introduce a common and robust approach to the protection of investors in these funds;
- Strengthen and deepen the single market, thereby creating the conditions for increased investor choice and competition in the EU, subject always to high and consistent regulatory standards; and
- Increase the accountability of AIFM holding controlling stakes in companies (private equity) towards employees and the public at large.

## **Have the United States introduced new rules for this sector?**

Effective regulation of the financial markets requires consistent and effective action to be taken in all major jurisdictions. In this and other areas, the commitments made by the G20 leaders provide the framework for this action.

In accordance with these G20 commitments, as in Europe, the United States have acted to strengthen regulation in this area. New rules on hedge funds and private equity were adopted in July as part of the Dodd-Frank Act. These rules will require the registration of managers of private equity and hedge funds with the Securities and Exchange Commission. Managers will be subject to substantive regulatory requirements and will be required to report regularly to supervisors for the purposes of systemic risk by the newly-created Financial Stability Oversight Council.

The objectives and approach of these reforms are consistent with those of the AIFMD.

## **How do the rules adopted differ from the Commission's proposal?**

The rules adopted by the Council of Ministers and European Parliament fully respect the objectives and structure of the Commission's proposal.

The 'all-encompassing approach' of the proposal is retained, covering all the major types of AIFM and alternative investment fund. This will ensure a level playing field and will help to minimise the risks of regulatory arbitrage. Strict rules have been included on, *inter alia*, transparency, the valuation and safekeeping of assets, risk and liquidity management, the use of leverage and the acquisition of companies.

The strong single market dimension of the proposal has also been preserved, introducing a single market passport for European managers and funds, as well as a 'third country passport', which will in due course become a single harmonised regime for third country access to investors in the EU.

The Commission has worked closely with Council and Parliament throughout to refine the detailed rules where necessary. In some areas, such as remuneration, new rules have been introduced by the Council and Parliament. These are consistent with the regulatory objectives and are welcomed by the Commission.

## **What is the 'passport'?**

The AIFMD introduces for the first time a genuine 'single market framework' for this sector, which will allow AIFM to 'passport' their services throughout the EU on the basis of a single authorisation.

Specifically, once an AIFM is authorised under the AIFMD in one Member State and complies with the rules of the directive, this manager will be entitled upon notification to manage or market funds to professional investors throughout the EU.

By creating a single regulatory and supervisory regime for all AIFM active in the EU, the AIFMD will help market participants to overcome the barriers and inefficiencies created by the current patchwork of national regulation. This will help to increase choice and competition, to the benefit of European investors.

## **When will the passport be made available to non-EU managers and funds?**

Alternative investments are a global industry and it is important that European investors have access to the best that the global market has to offer. At the same time, it is imperative that all AIFM active in the EU are subject to the same high standards of transparency and conduct, irrespective of where they, or the funds they manage, are located.

Following a limited transition period of two years, and subject to the conditions set out in the AIFMD, the passport will be extended to the marketing of non-EU funds, managed both by EU AIFM and AIFM based outside the EU. In accordance with the principle of 'same rights, same obligations', this approach will ensure a level playing field and a consistently high level of transparency and protection of European investors.

The phased introduction of the third country passports will allow European supervisors to ensure that the appropriate controls and cooperation arrangements necessary for the effective supervision of non-EU AIFM are operating effectively.

Before the third country passport is introduced and for a period of three years thereafter, national regimes will remain available subject to certain harmonised safeguards. Once this period has elapsed and on the basis of conditions set out in the AIFMD, a decision will be taken to eliminate the parallel national regimes. At this point, all AIFM active in the EU will be subject to the same high standards and will enjoy the same rights.

## **Will the Directive limit leverage in the hedge fund sector?**

Leverage employed by a wide variety of actors throughout the financial system has contributed to the fragility of the financial markets and amplified the effects of the financial crisis. It is therefore necessary to ensure that leverage is used responsibly and that the associated risks are understood and managed prudently.

The AIFMD introduces a range of transparency requirements and robust safeguards in relation to the use of leverage by AIFM. Each AIFM will be required to set a limit on the leverage it uses and will be obliged to comply with these limits on an ongoing basis.

AIFM will also be required to inform competent authorities about their use of leverage, so that the authorities can assess whether the use of leverage by the AIFM contributes to the build-up of systemic risk in the financial system. This information will be shared with the European Systemic Risk Board.

The AIFMD will also create powers for competent authorities to intervene to impose limits on leverage when deemed necessary in order to ensure the stability and integrity of the financial system. ESMA will advise competent authorities in this regard and will coordinate their action, in order to ensure a consistent approach.

## **How will the AIFMD protect investors?**

Investor protection is one of the core objectives of the AIFMD. The financial crisis has highlighted the range of risks to which investors in investment funds – both retail and professional – are exposed. The AIFMD introduces safeguards to ensure that investors in alternative investment funds are well-informed and adequately protected.

In particular, the AIFMD will increase the transparency of AIFM and the funds they manage and market. This will help investors to perform better due diligence. In addition, a variety of operational and organisational requirements will help to ensure that investors are appropriately protected. For example, the AIFMD will require that:

- conflicts of interest are avoided or managed and disclosed;
- AIFM employ adequate systems to manage risks to which the fund is exposed, and to ensure that the liquidity profile reflects the obligations towards investors;
- a fund's assets are safe-kept by an independent depositary subject to a high liability standard;
- valuation is performed properly and independently; and
- strict conditions are met when AIFM delegate functions to third parties.

Due to their complexity and risk, investment in many types of alternative investment fund is limited to professional investors. Consequently, the AIFMD creates rights for marketing to professional investors only. Member States are not prevented from making certain types of alternative investment fund available to retail investors. However, in this situation, competent authorities will be able to apply additional safeguards at national level to ensure that retail investors are adequately protected.

## **What is the purpose of the rules on pay?**

An important lesson of the financial crisis has been to ensure that remuneration practices in financial institutions do not create incentives for excessive risk-taking.

While bonus payments in banks have dominated the headlines in recent times, it is essential that sound remuneration principles be applied consistently throughout the financial services industry. Failure to do so may result in excessive risk-taking by individuals in certain sectors and may create opportunities for arbitrage as employees move between sectors.

Rules on remuneration practices are therefore being introduced in all major financial services sectors, including in the AIFMD. Specifically, AIFM will be required to implement remuneration policies that are consistent with and promote sound risk management and do not encourage risk-taking which is inconsistent with the risk profile and fund rules of the funds managed.

## **Will smaller managers be covered by the AIFMD?**

A comprehensive approach to regulation is necessary to ensure that standards are consistently high and to allow regulators to monitor risks wherever they arise in the financial system.

However, in order to avoid imposing disproportionate requirements on the very smallest AIFM and to allow supervisors to focus on those AIFM whose activities are of greatest relevance to financial stability, the AIFMD incorporates a system of 'de minimis' thresholds.

Depending on the type of fund they manage, AIFM whose assets amount to less than €500 million (for unleveraged funds with long 'lock-in' periods) or €100 million for other types of alternative investment fund will be subject to a tailored regime. These AIFM will be required to register with national authorities and to comply with harmonised transparency requirements, as well as additional requirements applied at national level.

The AIFMD also provides for the possibility for these AIFM to 'opt-in' so as to avail of passporting rights in return for full compliance with the AIFMD.

### **How will the depositary rules help investors?**

The functions of the depositary are critical for investor protection. When the entities charged with safeguarding the assets of the fund do not perform their duties effectively, investors stand to lose all or part of their investment. The experiences of Madoff and Lehman have highlighted the potential weaknesses in this area and the pressing need to clarify and strengthen investor protections.

Under the AIFMD, all AIFM will be required to ensure that the funds they manage appoint an independent and qualified depositary, which will be responsible for overseeing the fund's activities and ensuring that the fund's cash and assets are appropriately protected. Depositaries will be held to a high standard of liability in the event of a loss of assets and the burden of proof will reside with the depositary.

The AIFMD will also introduce a robust mechanism for the delegation of depositary functions and will regulate carefully the circumstances under which liability can be transferred to a sub-depositary, including when the sub-depositary is located outside the EU. This will allow investors to benefit from investment in third countries without compromising the level of investor protection.

The Commission is currently examining the corresponding depositary rules in the UCITS Directive with a view to producing proposals for their revision in 2011. This will ensure that the standard of protection afforded to investors in UCITS does not fall below that of the AIFMD. The rules adopted in the AIFMD will serve as a clear benchmark for this work; however the Commission will also assess whether additional safeguards are required to reinforce further the protection of retail investors.

### **How does the AIFMD regulate private equity buy-outs?**

Private equity and venture capital investment can play a crucial role in restructuring and financing companies in the EU.

The objective of the AIFMD is to introduce safeguards to increase the transparency of this type of investment towards the employees of the companies acquired and the public at large and to address potential risks to portfolio companies acquired by private equity funds, while minimising any competitive distortions that may result.

In particular, the AIFMD introduces rules relating to the disclosure of significant holdings by private equity funds. In the event of acquisition of control, the AIFMD will require the AIFM to ensure that the fund discloses relevant information in relation, for example, to the intentions with regard to the future business of the company and to the financing of the acquisition. The AIFMD also includes specific rules to mitigate risks to the long-term health of companies linked to 'asset stripping'.

### **What is the role of ESMA and the ESRB in the AIFMD?**

The AIFMD makes full use of the opportunities afforded by the recent reform of Europe's supervisory architecture.

Both ESMA and the ESRB will play an active role in the supervisory framework for AIFM, thereby strengthening the monitoring of risks on a cross-border basis; promoting the consistent application of the AIFMD across the EU; and facilitating the secure functioning of the passporting mechanisms for both European and non-European AIFM.

More information on the Directive on Alternative Investment Fund Managers is available at:

[http://ec.europa.eu/internal\\_market/investment/alternative\\_investments\\_en.htm](http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm)