

CP12/32***

Financial Services Authority

Implementation of the Alternative Investment Fund Managers Directive

Part 1



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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 1 February 2013.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2012/cp12-32-response.shtml.

Alternatively, please send comments in writing to:

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Email: cp12_32@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure.

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

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

Abbreviations used in this paper

AIF	alternative investment fund
AIFM	alternative investment fund manager
AIFMD	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010
AUM	assets under management
AUT	authorised unit trust
Basel 3	The Basel Committee on Banking Supervision agreement of 12 September 2010 on global minimum capital standards
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms of the FSA Handbook
BTS	binding technical standards
CAD	Directive 2006/49/EC on capital adequacy of investment firms and credit institutions
CASS	Client Assets sourcebook of the FSA Handbook
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CIS	collective investment scheme
COBS	Conduct of Business sourcebook of the FSA Handbook

COLL	Collective Investment Schemes sourcebook of the FSA Handbook
Commission	European Commission
CP	consultation paper
CP2	The FSA's second AIFMD consultation
CPM firm	collective portfolio management firm
CPMI firm	collective portfolio management investment firm
CRD 3	The third Capital Requirements Directive 2006/48/EC
DP	discussion paper
DPB	Designated Professional Body
EEA	European Economic Area
EFTA	European Free Trade Association
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
ESMA advice	Final Report on ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive published on 16 November 2011
ESRB	European Systemic Risk Board
EU	European Union, which includes the European Economic Area (EEA) unless otherwise stated
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Service
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
FUND	draft Investment Funds sourcebook of the FSA Handbook
G20	The Group of Twenty Finance Ministers and Central Bank Governors
GENPRU	General Prudential sourcebook of the FSA Handbook
HFACS	FSA Hedge Fund as Counterparty Survey

HFS	FSA Hedge Fund Survey
IPRU (INV)	Interim Prudential sourcebook for Investment Business of the FSA Handbook
ITS	implementing technical standards
JV	joint venture
Level 2 Regulation	The Commission regulation on AIFMD implementing measures (awaiting adoption at date of publication of this paper)
Member State	a Member State of the European Union
MiFID	Directive 2004/39/EC on Markets in Financial Instruments
NAV	net asset value
NURS	non-UCITS retail scheme
OEIC	open-ended investment company established under the OEIC Regulations
OEIC Regulations	Open-ended Investment Company Regulations 2001 (SI 2001/1228) (as amended)
OJ	Official Journal of the European Union
Part IV permission	a firm's permission to carry on a regulated activity granted under FSMA
PE	private equity
PII	professional indemnity insurance
PRA	Prudential Regulation Authority
Prospectus Directive	Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading (as amended)
QIS	qualified investor scheme
RAO	Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (as amended)
REIT	real estate investment trust
Remuneration Code	Chapter 19A of SYSC
RTS	regulatory technical standards
Solvency II	Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance

SPE	special purpose entity
SUP	Supervision manual of the FSA Handbook
SYSC	Senior Management Arrangements, Systems and Controls sourcebook of the FSA Handbook
TFEU	Treaty on the Functioning of the European Union
The Bill	The Financial Services Bill 2012
The Treasury	Her Majesty's Treasury
UCIS	unregulated collective investment scheme
UCITS	undertaking for collective investment in transferable securities
UCITS Directive	Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (recast)
UK Authorities	The Treasury and the FSA
UPRU	Prudential sourcebook for UCITS Firms of the FSA Handbook
VoP	variation of a Part IV FSMA permission

1

Overview

Part I of our consultation

- 1.1 This Consultation Paper (CP) is the first of two planned FSA consultations on rules and guidance to transpose the requirements of the Alternative Investment Fund Managers Directive¹ (AIFMD) into UK law. This means making changes to primary and secondary legislation and to the FSA Handbook. The Treasury and the FSA (the UK Authorities) are working closely together to achieve a streamlined implementation.
- 1.2 This paper follows on from our Discussion Paper DP12/1, published in January 2012. In that paper, we explained the background to the AIFMD and our general approach to implementing it in the UK. You may find DP12/1 useful for understanding some of the issues covered in this paper.
- 1.3 The Treasury is responsible for making legislative changes to ensure that our successor body, the Financial Conduct Authority (FCA), has the powers it needs to implement AIFMD. The Treasury will be consulting on this in its consultation document.

Implementing AIFMD

- 1.4 We must implement regulations transposing AIFMD by 22 July 2013. We have little scope for discretion in how we do this, because AIFMD is mostly a maximum-harmonising Directive², but Member States of the EU are allowed a limited number of options or derogations.³ Some of these can be exercised by national competent authorities (the FCA and equivalent regulatory bodies in other Member States). We propose to do this in a

1 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

2 A maximum harmonising Directive means that Member States have very limited discretion to apply additional requirements or requirements that differ from those in the Directive.

3 In Article 60 of AIFMD these are: articles 6 (individual portfolio management on a client-by-client discretionary basis), 9 (capital), 21 (depositories), 22 (annual report), 28 (private equity), 43 (marketing of AIFs to retail investors in a national jurisdiction) and 61(5) (transitional provision for depositories).

flexible way, to the extent that this is consistent with the FCA's statutory objectives, and this paper explains how we intend to use the derogations in specific areas.

- 1.5** Implementing AIFMD depends on the completion of a number of other areas of work being carried on at the European level, which we explain below. The delay that has occurred in completing this work affects what we are able to address in this paper. We are not yet in a position to analyse all the potential issues affecting firms, or to bring forward draft rules and guidance in every area.
- 1.6** However, we believe there is now sufficient certainty for us to consult on some matters. So, in this paper, we propose to address:
- the prudential regime for all types of alternative investment fund manager (AIFM), including capital requirements, risk of professional negligence, the liquid assets requirement and reporting matters, as well as changes affecting UCITS management companies;
 - the regime for depositaries, including the eligibility of firms to be an AIF depositary, the capital requirements, and the requirement to act independently; and
 - the Level 1 Directive requirements on AIFMs, including organisational matters, duties in relation to management of funds, and transparency obligations towards investors and the FCA.
- 1.7** The prudential regime for AIFMs and the regime for depositaries are the areas where we have to make choices about the best way to implement the Directive. In transposing other parts of the Directive by 'copy-out'⁴, we have generally avoided imposing any new requirements on firms beyond those in the Directive. Under the Financial Services and Markets Act 2000 (FSMA), we must undertake and consult on a cost benefit analysis (CBA) of the proposed changes to the Handbook, which is in Annex 1 of this paper.
- 1.8** This paper gives feedback on some of the implementation questions we raised in DP12/1. We received 78 responses to the DP from a diverse range of stakeholders, for which we are grateful. This feedback has been helpful and we have taken it into account when developing our implementation approach, in conjunction with the Treasury. As a result, we will not be publishing a separate Feedback Statement to DP12/1.

The European dimension of AIFMD

- 1.9** A key element in implementing the Directive will be the adoption of a European Commission regulation ('the Level 2 Regulation') specifying much of the detail with which AIFMs, depositaries and others will have to comply. At the time of publication, the Regulation had not been issued, so we are unable to describe its effects precisely here. We have explained in a number of places what we expect it to say, based on the technical advice

⁴ A 'copy-out' approach to Directive implementation means following in national law the words of the Level 1 text as closely as possible.

given to the Commission by the European Securities and Markets Authority (ESMA) in November 2011.⁵ However, firms need to bear in mind that the draft rules and guidance in this paper reflect the Level 1 Directive.

- 1.10** The measures in the Level 2 Regulation will be directly applicable in law, so we will not be consulting on it once it is published. Neither will we incorporate all of its contents in our Handbook. When we make the final rules, we will include references to relevant parts of the Regulation, where we think it will be particularly important to help firms understand the interaction between Level 1 and Level 2 measures.
- 1.11** ESMA is also engaged in various pieces of work to elaborate on the basic provisions of the Directive. The two most important ones for firms are:
- draft regulatory technical standards (RTS) and related material on types of AIFMs – this follows ESMA’s discussion paper of February 2012 and is expected to be published in Q4 2012⁶; and
 - final Level 3 guidelines on remuneration policies and practices – this follows ESMA’s consultation paper of June 2012 and is expected to be published in Q1 2013.
- 1.12** We will update you about the progress of this work in our second consultation paper (CP2).

Structure of this CP

- 1.13** Chapter 2 sets out our approach to consultation and transposition, in the context of both the European process and the reform of UK financial regulation due in the first part of 2013, which is when we expect the FSA to be replaced by the FCA and the Prudential Regulation Authority (PRA).
- 1.14** Chapter 3 describes our current understanding of the scope and application of the Directive to firms, and the areas in which further clarification is needed. Chapter 4 explains the requirement to be authorised under the Directive, and the effect of the changes that the Treasury will propose making to certain regulated activities.
- 1.15** Chapter 5 describes our proposals for the prudential regime applicable to AIFMs, as well as consequential changes affecting UCITS management companies.
- 1.16** Chapters 6, 7 and 8 describe how we intend to copy into our Handbook the other main Level 1 requirements of the Directive affecting the organisation and management activities of AIFMs, and the information they will need to disclose to us and to investors.
- 1.17** Chapter 9 describes our proposals for firms acting as depositaries.

⁵ ESMA’s technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 16 November 2011 ESMA/2011/379 www.esma.europa.eu/system/files/2011_379.pdf

⁶ Article 4(4) AIFMD requires ESMA to adopt regulatory technical standards.

- 1.18** Chapter 10 briefly explains some of the key issues relevant to the marketing of AIFs, which we will explain in more detail in CP2.
- 1.19** Each chapter outlines the following, where appropriate:
- the Directive article(s) being transposed;
 - the new rules firms must comply with under AIFMD and any related guidance;
 - the policy intention and its expected effect on firms;
 - matters where we propose, or are required, to make a discretionary decision (in each case a CBA is provided in Annex 1);
 - where it is clear, any existing requirements of our rules that will be disapplied for AIFMs;
 - whether an issue is likely to be affected by the Level 2 Regulation or expected ESMA guidelines; and
 - where an issue is not covered in this paper but is planned to be included in CP2.

Preparing for AIFMD

- 1.20** We currently expect that AIFMD will apply to a significant number of UK-based firms managing the assets of retail and professional investors. AIFMD also applies to the small number of firms authorised as depositaries. Non-EEA AIFMs will be affected if they are marketing AIFs under Articles 36 and 42 of the Directive (see Chapter 10).
- 1.21** Under the Financial Services Bill 2012 (the Bill), an AIFM will be subject to both conduct and prudential regulation by the FCA. This will also generally be the case for depositaries; however, systemically important depositaries such as major banks will be prudentially regulated by the PRA.
- 1.22** In this paper, we do not take into account proposals that the Treasury intends to make concerning options to apply differentiated regimes to certain smaller firms under Article 3 of the Directive. Depending on the outcome of the Treasury's consultation, we expect to address this subject in CP2.
- 1.23** Firms that will be, or expect to be, subject to the full Directive requirements will have many issues to consider, not of all which we can address at this time because of the various external dependencies that we have explained. Despite this uncertainty, we aim to give helpful indicative messages in this paper to firms that may become AIFMs or provide services to AIFMs, while awaiting finalisation of other legislative elements. We think that publishing this paper now will allow affected firms to begin making choices about their structuring and to continue planning for compliance with the Level 1 requirements. It will

also help firms that might wish to act as an AIF depositary to make decisions about their service offering.

- 1.24** We encourage you to keep up-to-date with European and domestic developments on AIFMD policy and implementation by referring to our publications and those of the Treasury, the European Commission and ESMA.

Fees

- 1.25** We propose to consult on our fee-raising arrangements for firms in scope of AIFMD in CP2. This is because the Treasury will be consulting on necessary changes to the Regulated Activities Order⁷ (RAO) as part of its own AIFMD consultation. The regulated activities carried on by firms under AIFMD impact, to some extent, our fee-raising arrangements. So we will need to make some changes to fee blocks A7 and A9⁸, although this will not affect the fee arrangements in 2013-2014 for firms in those fee blocks as at 1 April 2013.

Next steps

- 1.26** Please send us your responses to this paper by Friday 1 February 2013. This consultation period is slightly shorter than the three months we would normally aim to give stakeholders, because of the need to finalise our rules and guidance as early as possible before 22 July 2013.
- 1.27** We intend to publish CP2 in February 2013. The exact timing depends on several factors, including the further development of the Treasury's regulations, the timing of any further consultation the Treasury expects to carry out, and the further progress of European work on AIFMD. CP2 will have an eight-week consultation period, rather than the usual three months because of the nearness to the July 2013 implementation deadline. We set out in Annex 6 a summary of the subjects that we expect to cover in CP2.
- 1.28** We intend to publish one Policy Statement, relating to both parts of our consultation, in June 2013. The exact timing, including the point at which the Board of the FCA will be able to make final rules and guidance, will depend on external factors, including when the Treasury regulations become law. We will consider how we might give feedback at an earlier date on key issues arising from the consultation, to help stakeholders prepare for implementation. We refer in Chapter 2 to transitional arrangements for firms.

⁷ The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544, as amended.

⁸ The fee block structure is set out in FEES 4 Annex 1 of the FSA Handbook:
<http://fsahandbook.info/FSA/html/handbook/FEES/4/Annex1>

Who should read this CP?

- 1.29 This paper will interest investors (both retail and professional), fund managers, depositaries, MiFID firms, and non-EEA fund managers wishing to market and/or manage EEA or non-EEA funds in the UK, or elsewhere in the EEA.
- 1.30 It concerns investment companies not currently subject to FSMA authorisation and is important to service providers to the fund management industry, such as valuers, administrators and outsourcing specialists.
- 1.31 It will also interest representative trade bodies, business advisers and consultants, and other advisers involved, serving in or linked to the fund management industry in the UK.
- 1.32 Although UCITS firms and UCITS investment firms that do not manage AIFs are not within the scope of the Directive, this paper will interest them as we propose to amend the provisions that apply to them in UPRU and GENPRU/BIPRU respectively. Further details are set out in Chapter 5.

Key messages

An iterative consultation process

Consultation timeline

We are consulting now to give firms affected by AIFMD adequate time to prepare for implementation. This also gives us time to prepare given the challenges of regulatory reform.

Consulting where we have sufficient certainty

We are consulting where we believe we have sufficient certainty to do so. This consultation focuses on the implementation of the Directive's Level 1 requirements, with reference, where applicable, to the expected Commission Level 2 Regulation on AIFMD implementing measures.

Further consultation

In the light of ongoing work at European level by the Commission and ESMA and the effect of this on national timelines, we will consult on Part II of AIFMD implementation in February 2013, following the Treasury's second AIFMD consultation expected in January 2013. We expect the consultation period for Part II of our AIFMD consultation to run for about eight weeks.

Limited scope for discretion*Maximum harmonisation*

This consultation does not reopen discussions on policy decisions (as set out in the Directive and reflected in our proposed rules) which have been agreed by all Member States under EU processes.

Copy-out

We have taken a coherent copy-out approach to transposition, following the words of the Level 1 text as closely as possible while trying to ensure that rules and guidance are expressed in clear language and organised in a logical way.

Where we have discretion

Where Member State discretion is given in the Directive or we have policy choices to make, such as for prudential and depositary requirements, we invite comment on our policy proposals as explained in the relevant sections and reflected in the proposed rules.

CP closing date

You have 11 weeks to send us your responses, by 1 February 2013.

CONSUMERS

AIFMD is mainly directed at firms offering asset management services to professional investors. Many of these firms do not promote their products or services to consumers more generally.

However, given that one of the main objectives of AIFMD is to achieve an appropriate level of investor protection for retail, professional and institutional investors, our proposals may be of wider interest to consumers.

2

Implementation

- 2.1** This chapter covers our two-part approach to the AIFMD consultation process, continuing European work on the Directive and the impact of UK regulatory reform on implementation. It also covers strategic decisions relating to the retail authorised funds regime, the structure of the new investment funds sourcebook, and some transitional matters.

Our approach to consultation

- 2.2** Our AIFMD consultation will be in two parts because of a number of significant European dependencies that affect the manner and timing of transposition of AIFMD in the UK. Where European dependencies (which we explain below) are clarified after the publication of this paper, we will cover any implementation matters arising from them in CP2. We will also set out in CP2 the proposed FCA rules to implement the Treasury's proposals for any sub-threshold AIFM regimes.⁹
- 2.3** We are consulting later than we had hoped to, considering the 22 July 2013 implementation deadline. We have had to balance the difficulties around the ongoing uncertainties at European level and the effect this is having on national implementation, against the need to help firms to continue to plan for AIFMD readiness. This was an important objective of DP12/1.
- 2.4** We think this approach is preferable to publishing a single larger consultation paper in Q1 2013, which would have given firms even less time to plan for AIFMD.
- 2.5** We are separately consulting on some minor changes to the Listing Rules in the light of the AIFMD, based on feedback received in relation to questions 55 to 57 in DP12/1. This is set out in CP12/25, *Enhancing the effectiveness of the Listing Regime and feedback on CP12/2*, which closes on 2 January 2013.

⁹ These are regimes permitted under Article 3 AIFMD (AUM below €100 million/€500 million).

Contextualising AIFMD

- 2.6 AIFMD is part of a significant reform programme put forward by the EU legislature to extend appropriate regulation and oversight in the financial services sector to all persons and activities that might embed significant risks. The aims of AIFMD include:
- establishing a harmonised EU framework for monitoring and supervising the risks that AIFMs could pose to financial stability, and to investors, counterparties and other financial market participants;
 - enhancing supervisory practices and convergence among EU competent authorities to support timely and pre-emptive action to prevent market instability and the build-up of systemic risk in the European financial system;
 - improving investor protection by imposing new depositary standards and enhanced transparency through new investor disclosure rules and mandatory reporting to competent authorities; and
 - fostering efficiency and cross-border competition by deregulating national barriers and creating level playing fields through harmonised rules on an EU-wide passport for full-scope EEA AIFMs to market and manage AIFs from 23 July 2013.¹⁰

The European process and the legal framework of AIFMD

- 2.7 We explain the key concepts and legal instruments of European law relevant to AIFMD in Annex 5. Readers may find it helpful to refer to this Annex to better understand the content which follows.
- 2.8 We posed a number of questions in DP12/1 with the expectation that some of the Directive's implementing measures would be adopted using Level 2 Directives.
- 2.9 Since publication of DP12/1, the Commission has, however, decided that all the detailed Level 2 implementing measures should be adopted using EU regulations.¹¹ These will be directly applicable to firms and supervisory authorities in UK law, without requiring any transposition by the UK Parliament, so they are not subject to FSA consultation. This means that some of the possible discretions we described in DP12/1 will not be available.
- 2.10 For the Level 2 Regulation to come into force, it needs to be adopted and agreed by the Commission, European Parliament and European Council. At the time of publication, this process has not yet begun.

10 From 23 July 2013 there is no passport for non-EEA AIFMs. This will apply from 2015/16 if the Commission adopts a delegated act for such a passport, based on a positive report by ESMA – see article 62 AIFMD. However, from 23 July 2013 non-EEA AIFMs may continue to market AIFs in the national jurisdictions of Member States that have opted to permit national private placement. This is discussed further in Chapter 10.

11 These are essentially the Level 2 Regulation and further expected regulations on the 'Member State of Reference' for the non-EEA passport and on home/host State competent authority supervision).

- 2.11 In addition to the delegated acts that form the Level 2 Regulation, the Level 1 text contains numerous provisions requiring or permitting other types of subordinate measures, binding technical standards and Level 3 guidelines. These measures are either discretionary or mandatory.¹²
- 2.12 ESMA has prepared draft regulatory technical standards on types of AIFM under article 4(4) AIFMD and will formally consult on these standards and any related Level 3 guidelines. These are expected to be in place before 22 July 2013.
- 2.13 We are continuing to work within ESMA to bring its AIFMD work due for July 2013 to a conclusion.
- 2.14 Since it is expected that Iceland, Liechtenstein and Norway will also implement AIFMD, we have referred throughout this paper to 'EEA' AIFMs and AIFs rather than to 'EU' AIFMs.

Alignment with regulatory reform

Regulatory reform

- 2.15 We are preparing for AIFMD at the same time as undergoing significant strategic and operational change under the government's regulatory reform programme. The principal outcome is that the FSA is expected to be split into the FCA and the PRA in 2013. The Financial Services Bill, which gives effect to these changes, is likely to become law in Q1 2013, with the two new regulators expected to assume their responsibilities on 1 April 2013.
- 2.16 The FCA will be responsible for the conduct and wholesale supervision of financial services firms, as well as the prudential supervision of firms not supervised by the PRA.
- 2.17 The FCA's stated strategic objective is to ensure that the relevant markets function well. To support this, it has three operational objectives. These are to secure an appropriate degree of protection for consumers, to protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers.

Approach to AIFM supervision: judgment-based supervision

- 2.18 In line with the approach set out in Journey to the FCA¹³, the FCA will form its judgments based on a comprehensive, forward-looking view of a firm, to assess all potential risks that could affect the AIFM sector and other sectors, the markets and investors. Firms' own risk management is expected to be forward-looking.

¹² For example, the provisions for the non-EU AIFM passport, to be operative from 2015/16, require a number of binding technical standards and Level 3 guidelines to be in place. We expect this work to be undertaken by ESMA after the 22 July 2013 implementation date, ahead of 2015/16. See articles 35 and 37-41 AIFMD.

¹³ http://content.yudu.com/A1z7zd/journey-to-the-fca/resources/index.htm?referrerUrl=http%3A%2F%2Fwww.fsa.gov.uk%2Fabout%2Fwhat%2Freg_reform%2Ffca

- 2.19** The expectation that the FCA will make early and pro-active supervisory interventions aligns with the principle in AIFMD that national competent authorities apprehend systemic risks and intervene to manage or mitigate those risks. In addition to this, examples of how key elements of AIFMD should align with the proposed approach of the FCA include:
- an emphasis on the primary role played by firms' management in understanding the risks their firm faces and ensuring effective governance and risk management, with appropriate controls and procedures;
 - an emphasis on the importance of both sufficient levels of regulatory reporting and disclosure to markets and investors;
 - strengthened cooperation and coordination between national and European regulators, through harmonised regulatory approaches and supervisory practices across Europe; and
 - new understandings between European and non-EEA regulators for enhanced cross-border supervisory cooperation.

Two new Handbooks

- 2.20** We are currently working on the new PRA and FCA rulebooks, which will become effective when these two new regulators acquire their legal powers (we refer to this as 'legal cutover'). The overall approach to amending the FSA Handbook to be ready for legal cutover is based on only making the changes that are required to implement the Bill and to support the creation of the new regulatory structure. While the draft AIFMD rules will be consulted on by us as the FSA, they are likely to be made by the FCA after legal cutover.
- 2.21** This approach aims to control the degree of necessary change for the regulators to operate and for firms at legal cutover. A key element of this approach is that when the PRA and FCA acquire their new powers, provisions in the existing FSA Handbook will be adopted, or 'designated' by the PRA, by the FCA or by both regulators, to form new PRA and FCA rulebooks. As a result, the majority of the provisions in the existing FSA Handbook will be carried forward to the new regulators in their respective rulebooks. Readers will be able to see which provisions have been adopted, or 'designated', by each regulator to form new PRA and FCA rulebooks.
- 2.22** From legal cutover, the PRA and FCA will amend those provisions in line with their objectives and functions, consulting and coordinating with each other as appropriate. More substantive changes to the existing FSA Handbook are required to align the new rulebooks with the future objectives, functions and regulatory procedures of the PRA and FCA.

Funds for non-professional investors

Non-UCITS retail schemes

- 2.23** In DP12/1 we explained that the UK Authorities have discretion whether to allow specific regimes for categories of fund that can be marketed to retail investors.¹⁴ We confirm it is the intention to treat authorised non-UCITS retail schemes (NURS) as AIFs that may be marketed to ‘retail investors’ within the meaning of Article 43 of AIFMD. This will mean that, as now, such funds may be marketed to the general public.
- 2.24** We asked respondents to DP12/1 what changes, if any, we should make to the current NURS regime¹⁵. The majority wished to see the NURS regime maintained, except where the requirements of AIFMD affect existing rules and changes are needed. We agree that AIFMD implementation should not be used as an opportunity to make widespread changes to the NURS regime. So, although some NURS rules may need modifying to meet AIFMD requirements, where the FCA can exercise discretion we will generally not be seeking to make changes. We will address this issue in more detail in CP2.

Qualified investor schemes

- 2.25** Qualified investor schemes (QIS) are authorised funds intended primarily for professional investors, but they may be sold to certain limited categories of retail investors, as is the case for unregulated collective investment schemes (CIS) more generally. All these funds will fall within the scope of Article 43, so we intend to continue allowing them to be marketed to limited categories of investors. This policy is of course subject to our proposals in CP12/19¹⁶ to restrict further the categories of non-professional investors to whom ‘non-mainstream pooled investments’ (including unregulated CIS and QIS) may be promoted. If those proposals are carried through, they will not affect the general principle of treating these categories of fund as ‘retail’ under Article 43 – where, for example, units are sold to retail clients certified as ‘sophisticated investors’.
- 2.26** We asked respondents to DP12/1 what changes, if any, we should make to the current QIS regime.¹⁷ There was less consensus than for NURS: most respondents argued to keep the QIS requirements, on the basis that they provide a useful bridge between mainstream retail funds and unregulated CIS, as well as being tax-efficient for professional investors who do not enjoy tax-exempt status. However, some stakeholders thought that many of our specific rule requirements should be dropped, so that such funds only need to comply with the minimum AIFMD requirements.
- 2.27** We accept the arguments for retaining QIS, and propose to take a similar approach to the QIS regime as for NURS, making rule changes only where it is necessary to transpose the

¹⁴ DP12/1 Chapter 9 at paras 9.21-9.33.

¹⁵ Questions 58 and 59 of DP12/1.

¹⁶ CP12/19 *Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes*, August 2012.

¹⁷ Question 66 of DP12/1.

Directive correctly. We do not consider that all non-AIFMD rules applying to QIS should be removed. This would leave no meaningful distinction between a QIS and an unregulated CIS in terms of their regulatory obligations, and we think that granting authorised status to a fund should bring with it a higher standard of investor protection.

Alignment between retail AIFs and UCITS schemes

- 2.28** In DP12/1, we also asked whether we should consider aligning requirements for UCITS management companies and AIFMs where the Directives contain common requirements. A majority of respondents broadly supported this idea, although some thought it would damage competition if additional AIFMD-based requirements were imposed on UCITS schemes, or if professional-only funds were also subjected to retail investor protection measures.
- 2.29** We are mindful of the government's stated intention to avoid 'gold-plating' when implementing Directives, as well as the burden on and costs for firms of having to make operational changes over and above what is strictly necessary. So we have decided not to try to align the requirements of the two directives in our Handbook beyond what is already in place for authorised funds. We may reconsider this issue in the future, when we know the outcome of the Commission's proposals for further changes to the UCITS Directive.

Non-UCITS recognised schemes

- 2.30** The Treasury will consult in due course on the treatment of non-UK funds (other than EEA UCITS) that can be promoted to the general public. At present, such funds may only be promoted if they are recognised schemes under sections 270 or 272 of FSMA. We propose to deal with any resulting changes to our rules and guidance either in CP2 or a subsequent consultation paper.

Transposing AIFMD into the Handbook

- 2.31** We intend to transpose AIFMD requirements into the Handbook in the way we explained in DP12/1. We said we would, where appropriate, distribute Directive requirements between the most suitable parts of the Handbook; for example, rules for systems and controls in SYSC and rules for conduct of business in COBS. At the same time, we proposed a new sourcebook to replace COLL, to accommodate both AIFMD and expected future changes to the UCITS Directive.
- 2.32** Some respondents to DP12/1 did not agree with this suggested approach and asked instead for COLL to be retained and a new, separate sourcebook to be created for other funds and fund managers subject to AIFMD. The reasons they gave were convenience and ease of reference for firms managing only authorised funds; it would be less disruptive to them than introducing a single comprehensive funds sourcebook under the banner of AIFMD implementation.

- 2.33** We considered other possible approaches carefully before we published DP12/1, but concluded that they would not be best for the majority of future AIFMs, and this remains our view. The single sourcebook that we are proposing, containing a set of rules common to all AIFMs, and with additional rules applicable to categories of AIFs (such as non-UCITS authorised funds), is likely to be more convenient for most users. We think it will be possible to include UCITS and their management companies in this structure without unduly complicating readers' navigation of the rules and guidance.
- 2.34** The draft instrument in Appendix 1 of this paper consists of amendments to existing sourcebooks and a new module, to be known as the Investment Funds sourcebook (FUND). FUND will in due course entirely replace COLL, although there will be transitional provisions to ease the process, particularly for rules applying to UCITS schemes. We will address this in more detail in CP2.
- 2.35** We also proposed in DP12/1 that we would reorganise Handbook material relating to the prudential requirements for UCITS management companies. We intend to proceed with these changes.

Structure of the Investment Funds sourcebook

- 2.36** FUND will be a single sourcebook combining requirements for AIFs, UCITS and the companies that manage them. It will do this in a way that should make it easy for readers to distinguish which requirements apply to which type of fund or fund manager. The new sourcebook will include rules and guidance on all subjects that are currently addressed by COLL, but it will have a much wider scope, to reflect the range of fund managers, depositaries and other firms that are affected by AIFMD.
- 2.37** The proposed structure of FUND organises the subject-matter according to the range of funds and firms it applies to, as follows:

Chapter	Subject matter	Scope
1	Introduction	all firms managing AIFs and UCITS, all AIFs and UCITS
2	Authorisation	all firms managing AIFs and UCITS, all authorised AIFs and UCITS
3	Requirements for managers of AIFs	all AIFMs and AIFs
4	Common requirements for all retail funds	all AIFMs managing NURS and QIS, all UCITS management companies and UCITS schemes
5	Additional requirements for retail alternative investment funds	all AIFMs managing NURS
6	Additional requirements for qualified investor alternative investment funds	all AIFMs managing QIS
7	Additional requirement for UCITS funds	all UCITS management companies and UCITS schemes
8	Additional requirements for UCITS and AIF master-feeder arrangements	all AIFMs and UCITS management companies that manage UCITS/NURS/QIS feeder funds or master funds

9	Suspension of dealings and termination of authorised funds	all AIFMs managing NURS and QIS, all UCITS management companies and UCITS schemes
10	Operating on a cross-border basis	all UK AIFMs and UCITS management companies passporting into another EEA State, all EEA firms passporting into the UK under an AIFMD or UCITS Directive right
11	Recognised funds	all s.264 (UCITS) recognised schemes and all s.270 and s.272 recognised schemes

- 2.38** Consequently, AIFMs not managing authorised funds and that deal exclusively with professional investors, will need to consider only the first three chapters of FUND (and Chapter 10 where they are exercising passporting rights).
- 2.39** This CP contains proposed rules and guidance for chapter 3 of FUND. We shall consult on the remaining material in CP2.

Transitionals

- 2.40** The AIFMD allows firms that are already managing or marketing AIFs, before 22 July 2013, a transitional period of 12 months to comply with the relevant laws and regulations and to apply for authorisation. The Treasury regulations propose that a firm carrying on the activity of managing one or more AIFs as at 22 July 2013 will be permitted to continue its collective portfolio management activities, subject to the Handbook rules applying immediately before that date. A firm which currently carries on business as an AIFM without needing a Part IV permission – for example, an internally managed investment company – will be able to benefit from this transitional period. All these firms must, however, be AIFMD-compliant and have submitted an application for authorisation by the end of that 12-month period.
- 2.41** The Directive requires national competent authorities normally to decide applications for authorisation within three months of their submission. We expect firms to submit an application for an AIFM authorisation or a variation of permission (VoP) by 22 July 2014.
- 2.42** A UK firm that wishes to begin managing an AIF for the first time after 22 July 2013 will not benefit from any transitional provision. It will first have to apply to the FCA for authorisation and be fully compliant with the Directive requirements before it can begin to manage an AIF. The same is true where the firm wishes to begin marketing AIFs in the UK or any other EEA Member State.
- 2.43** There are no general transitional provisions relating to depositaries, in terms of their readiness to act for AIFs from July 2013. A firm will have to hold the relevant Part IV permission to be appointed as depositary of an AIF in accordance with the Directive, so these firms should consider carefully what they will need to do to be in a position to offer that service from the date of implementation, or shortly afterwards. The transitional

provision for AIFMs wishing to use an EEA credit institution as an AIF depositary is explained in Chapter 9.

- 2.44** We will provide further information on the position for depositaries of AIFs managed by sub-threshold AIFMs in CP2.

3

Scope

- 3.1** This chapter covers matters of scope insofar as this is possible given continuing work by ESMA and the Commission. It is intended to be helpful by indicating to firms whether they are managing AIFs and therefore likely to be in scope of the Directive.

Meaning of 'AIF' and 'AIFM'

- 3.2** The terms 'AIF' and 'AIFM' are defined in Article 4 of the Directive. AIFMs are 'legal persons whose regular business is managing one or more AIFs'.¹⁸ As a result, the definition for AIFMs is heavily dependent on the definition of an AIF.
- 3.3** An AIF is a collective investment undertaking that raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and that does not require authorisation under the UCITS Directive.¹⁹ This definition captures a very broad group of collective investment undertakings, apart from those authorised as UCITS schemes in the UK or other EEA Member States. Each AIF managed within the scope of this Directive must have a single AIFM.²⁰
- 3.4** The scope provisions in Article 2 AIFMD refer to different categories of AIFMs and AIFs based on their place of establishment:
- AIFMs based in the EEA managing AIFs based in the EEA, whether the AIFM and the AIF are based in the same Member State or different Member States.
 - AIFMs based in the EEA managing AIFs outside of the EEA, whether or not those AIFs are marketed in the EEA.
 - AIFMs outside the EEA managing AIFs based in the EEA.
 - AIFMs outside the EEA marketing AIFs in the EEA, whether those AIFs are based in the EEA or outside of the EEA.

¹⁸ Article 4(1)(b) AIFMD. See definition of 'alternative investment fund manager' in Glossary.

¹⁹ Article 4(1)(a) AIFMD. See definition of 'alternative investment fund' in Glossary.

²⁰ Article 5(1) AIFMD.

- 3.5 For the purpose of transposing these categories into our rules, we propose to add the defined terms ‘UK AIFM’, ‘EEA AIFM’ and ‘Non-EEA AIFM’ to the Glossary.

Regulatory technical standards on types of AIFMs

- 3.6 As mentioned in Chapters 1 and 2, ESMA is currently developing these RTS having issued a Discussion Paper earlier this year.²¹ Because these standards have not yet been finalised, a detailed discussion of the AIFMD perimeter is beyond the scope of this CP. We will consider in CP2 the impact on the AIFMD perimeter of any draft material that ESMA publishes for consultation.

AIFMD regulatory perimeter

- 3.7 Although we cannot make definitive statements in this CP about which funds and managers are in scope, we can give some indication of our thinking. Although AIFMD is principally targeted at the managers of funds that only have professional investors, it will apply to all managers of authorised investment funds that are not UCITS. These are NURS and QIS; we plan to consult on our approach to the regulation of these funds under AIFMD in CP2.
- 3.8 We would expect the managers of most unregulated collective investment schemes (UCIS), managed or marketed in the UK, to be subject to the Directive. UCIS include UK-based unauthorised unit trusts and limited partnerships investing in a range of assets such as transferable securities, derivatives, real estate, private companies, fine art, wine, etc. UCIS are primarily targeted at professional investors, but may be sold to certain types of retail investor under certain exemptions.²²
- 3.9 The Directive applies to funds structured in any legal wrapper²³, which means that managers of investment companies are likely to be subject to the Directive, whether or not the investment company is listed, or is internally or externally managed.
- 3.10 It is also likely that managers of offshore investment funds marketed to retail or professional investors in the UK will be subject to the Directive. We do not have data on the number of offshore investment funds marketed to professional investment in the UK, because the managers or agents are not required to notify us of their marketing activities.
- 3.11 Finally, we understand that asset managers structured as limited partnerships subject to the law of England and Wales will not be able to become AIFMs. This is because limited partnerships subject to the laws of England and Wales, unlike some other jurisdictions, do not have separate legal personality.

21 Discussion paper on Key concepts of the Alternative Investment Fund Managers Directive and types of AIFM available from www.esma.europa.eu/system/files/2012-117.pdf

22 COBS 4.12. See sections 238 and sections 21 of FSMA and accompanying secondary legislation.

23 See Recital 6 AIFMD.

Types of AIFs

- 3.12** The definition of an AIF determines generally what the scope of the Directive is, but for some undertakings the definition is not precise enough to give certainty about whether it is an AIF. To distinguish whether certain undertakings are AIFs, firms will need to consider several factors. For example, an entity may be out of scope if its main business is a commercial activity such as manufacturing goods or constructing buildings, or providing services to customers. An AIF may own a manufacturing or service company, or land that is being developed, but it does not participate directly in the commercial activity being carried on by that asset. Another indicative factor that might place an entity out of scope would be the presence of a substantial number of employees carrying on commercial activities, whereas an AIF would generally employ relatively few people to manage its assets.
- 3.13** We note below some types of entity that may be AIFs depending on their specific characteristics. We encourage firms to analyse the entities or other structures under their management against the Directive's AIF definition and take account of the forthcoming ESMA guidelines.
- 3.14** Property investment firms: Some of these investment firms have the characteristics of an investment fund such as pooled investment, a defined investment policy, etc, but they may also have characteristics of a commercial company, such as employees, and may perform service activities such as property construction and development. Real estate investment trusts (REITs) are a type of property investment firm, and accordingly we consider that they may or may not be AIFs depending on the specific activities they carry on.
- 3.15** Joint ventures: Joint ventures may have fund-like characteristics such as capital-raising, passive participants, defined investment policies, etc. However, where investors in a given joint venture structure have substantial management control over strategic decisions, there is likely to be a contrast with the governance of typical AIFs. Although Recital 8 of AIFMD excludes joint ventures in principle, all joint ventures will nevertheless have to review their structures against any final Commission measures or ESMA guidelines.
- 3.16** Family office vehicles and private wealth undertakings: Recital 7 states that 'Investment undertakings, such as family office vehicles that invest the private wealth of investors without raising external capital should not be considered to be AIFs'. Based on the recital, the key factor for family offices and private wealth undertakings seems to be whether external capital is being raised. We expect more detail on this concept from ESMA.
- 3.17** Internally-managed AIFs: The Directive allows for internally-managed AIFs, where the legal form of the AIF permits it, and no external AIFM is appointed.²⁴ In the context of the UK market, some examples will be certain investment companies whose board retains control of all investment management functions, where no external manager has been appointed, and where the investment company employs staff to assist with investment management decisions.

²⁴ Article 5(1)(b) AIFMD.

Q1: Although we will return to this issue in a later consultation, once ESMA has completed its work on types of AIFM, do you have any concerns or questions regarding our approach to AIFMD scope as described in this chapter?

AIFMD provisions applicable principally to private equity fund managers

3.18 Articles 26-30 of AIFMD contain requirements for managers which acquire control of unlisted companies. We did not mention these provisions in DP12/1. The Treasury in its consultation will explain that it intends to designate the FCA as the competent authority for these provisions. We will revisit the application of these provisions in CP2.

4

Authorisations

- 4.1 The Directive requires AIFMs to be authorised in their Home State to manage an AIF, from 22 July 2013 (subject to the transitional provisions, as explained in Chapter 2). Firms authorised in accordance with Article 6 of the Directive and subject to its full requirements are referred to in the Handbook as ‘full scope UK AIFMs’.
- 4.2 The Directive gives Member States discretion to permit a lighter regime of registration for certain sub-threshold AIFMs. This is covered in the Treasury’s consultation document. We will consult on proposals for how the authorisation or registration processes will be applied to firms that are not full scope UK AIFMs in CP2.

Regulated activities

- 4.3 The Treasury also intends to change how the Regulated Activities Order (RAO) categorises fund management activities. At present, fund operators must be authorised to carry on the activity of establishing, operating and winding up a collective investment scheme (CIS). There is a separate activity of acting as sole director of an open-ended investment company (OEIC). Acting as trustee of an authorised unit trust (AUT) or depositary of an OEIC are also specified activities.
- 4.4 The Treasury consultation document explains how the RAO activities will be aligned with European legislation, through creating the new regulated activities of:
- managing an AIF;
 - managing a UCITS;
 - acting as a depositary of an AIF; and
 - acting as a depositary of a UCITS.
- 4.5 Firms that are authorised to carry on the new regulated activities of managing an AIF or a UCITS will not need to hold a permission to establish and operate a CIS in relation to the AIF or UCITS they have been authorised to manage. Where a person other than the

operator of a CIS (that is an AIF) is authorised to manage that AIF, the operator will no longer need to hold a separate permission to operate the CIS – it will cease to be a regulated activity as long as there is an authorised person acting as the AIFM.

- 4.6** The activity of establishing and operating a CIS will be retained, but will only need to be held where a firm operates a CIS that is neither an AIF nor a UCITS. The activity of sole director of an OEIC will be abolished, as the activities of managing an AIF or a UCITS will replace it entirely.
- 4.7** Managing an AIF will comprise all activities listed in Annex I of the Directive, if the AIFM itself is appointed to perform them (whether or not it then delegates the performance to a third party). The AIFM will always be responsible for the investment management functions, but (where an AIF has an external AIFM) the governing body of the AIF may appoint another person to perform some or all of the activities listed in paragraph 2 of Annex I. If it does, that person will not need to be authorised to manage an AIF, but may need to be authorised to perform another regulated activity (for example, if they effect the issue and redemption of units or shares).²⁵
- 4.8** An AIFM will not need to hold separate permissions for other regulated activities (such as managing investments) that it carries out ‘in connection with, or for the purposes of managing the assets of AIFs and UCITS’. This covers core activities of the management of the property of the AIF or UCITS scheme, such as making investment decisions and dealing in securities or other assets, but not activities such as the management of individual portfolios where they happen to be carried out by the same firm.
- 4.9** An AIFM that is responsible for some or all of the activities listed in Annex I paragraph 2 (for example, dealing with customer enquiries) will therefore be carrying on a regulated activity when providing any of those services, even though the service would not be a regulated activity if carried out by another person. However, categorising the activities of an AIFM in this way provides clarity and certainty for AIFMs wishing to use the single market passport to provide AIF management services in other Member States.

Authorisation of AIFMs

- 4.10** A full scope UK AIFM will need to be authorised under Part IV of FSMA by the FCA. Firms that already hold a Part IV permission to carry on a regulated activity and consider they should be authorised as an AIFM, may seek a variation of permission (VoP).
- 4.11** We are considering whether we might apply a ‘grandfathering’ process to VoPs for those firms currently holding the permissions of operating a CIS or acting as sole director of an OEIC, and will tell firms in due course what we intend to do. Some firms with the Part IV permission of managing investments may decide they should also be authorised as AIFMs,

²⁵ A closed-ended investment company that is internally managed may be authorised as its own AIFM, but it will not be an authorised CIS under Part XVII of FSMA.

where they are providing services to a vehicle that will be an AIF. We expect to assess these applications for VoPs on an individual basis.

- 4.12** The Directive sets out specific standards which a firm must meet to be authorised as an AIFM. Some of these requirements will be transposed through secondary legislation; the rest (Article 8(1)(c)) will be transposed in SYSC 4.2.7R and 4.2.8R.
- 4.13** The FCA does not expect to begin accepting applications for authorisation or a VoP from prospective AIFMs before 23 July 2013. In the ordinary course, where an applicant provides all the relevant information, we will determine an application for authorisation or VoP within the three-month period specified in the Directive. In certain circumstances we may prolong this period by a further three months, provided we notify the applicant accordingly, in line with the Directive's requirements. An application for authorisation will need to contain at least the following information about the AIFM (we may ask for more):
- the identity of the persons who conduct its business;
 - the identity of shareholders who have 10% or more of the capital or voting rights in the AIFM and the size of their shareholdings;
 - its organisational structure and how it intends to comply with the Directive;
 - its remuneration policies and practices; and
 - its delegation arrangements.
- 4.14** The application must also contain the following information about each AIF under management:
- its investment strategies;
 - if it is a feeder AIF, the jurisdiction where its master AIF is established;
 - the instrument constituting the fund;
 - the arrangements made for the appointment of the depositary; and
 - the information to be disclosed to investors in accordance with FUND 3.2.2R.

Authorisation of UCITS management companies

- 4.15** A firm that currently acts as a management company of a UCITS will already hold a Part IV permission to establish, operate and wind up a CIS or to act as sole director of an OEIC. The Treasury is proposing to provide in its regulations that all UCITS management companies will automatically be transferred to the activity of managing a UCITS. Where the firm manages AIFs as well, it will be subject to the same authorisation or VoP processes as any other AIFM for that part of its business.

Other permitted activities of AIFMs and UCITS management companies

- 4.16** Both AIFMD and the UCITS Directive restrict the range of activities that a collective portfolio manager may carry out. The same firm can manage both UCITS and AIFs if it holds the necessary authorisations, so it will be possible for the Part IV permissions of managing an AIF and managing a UCITS to be held together.
- 4.17** An AIFM and a UCITS management company may also be permitted to carry out certain other activities that would otherwise be regulated under MiFID. So those firms may hold the Part IV permissions necessary to enable them to perform some or all of the services allowed by Article 6(4) of AIFMD and Article 6(3) of the UCITS Directive.²⁶ We expect to apply limitations or requirements to the permissions where necessary to make it clear that the firm cannot be a manager of AIFs or UCITS and simultaneously perform the full range of activities possible under a MiFID authorisation.
- 4.18** There is currently some uncertainty about whether an AIFM that carries out ‘MiFID services’ under Article 6(4) has the right under AIFMD to passport those services to other Member States. Our provisional view is that they do have such a right, but some other Member States think they would need to be authorised under either MiFID or the UCITS Directive to do so (and any MiFID licence would have to be limited to those specified activities). However, in practice, a UK firm will hold the same Part IV permissions, whichever Directive they are considered to derive from²⁷, so UK AIFMs are likely to be able to provide those services elsewhere in the EEA.

Authorisation of depositaries

- 4.19** The Treasury consultation document explains that the existing regulated activities of acting as trustee or depositary of an authorised fund will be replaced by the two new depositary activities mentioned in paragraph 4.4. Chapter 9 of this paper explains which UK firms can be appointed as depositary of an AIF and what requirements they have to meet.
- 4.20** The Treasury is proposing to provide in its regulations that firms with Part IV permissions to act as trustee of an AUT or depositary of an OEIC will, where the AUT or OEIC is a UCITS, automatically be transferred to the activity of acting as a depositary of UCITS.
- 4.21** We are currently considering whether we can apply a ‘grandfathering’ process to VoPs for the activity of acting as a depositary of AIFs, and will tell firms in due course what we intend to do.

²⁶ Rules in FUND 2 giving effect to these options will be consulted on in CP2.

²⁷ Except that an AIFM is permitted to carry out the activity of receiving and transmitting orders under AIFMD but not under the UCITS Directive.

External valuers

- 4.22** The Treasury does not intend to make a new regulated activity of acting as the external valuer of an AIF. So, where an external valuer is appointed by the AIFM in accordance with FUND 3.9.7R, there is no requirement for the valuer to be an authorised person.

5

Prudential requirements for fund managers

- 5.1** This chapter covers the prudential regime for all types of AIFM, including capital requirements, professional negligence risks, the liquid assets requirement and reporting matters. It also covers certain changes to our prudential rules affecting UCITS management companies.

Capital, PII and reporting requirements for AIFMs and UCITS management companies

- 5.2** A firm currently authorised by the FSA to manage AIFs and/or UCITS must comply with the capital requirements of one of the following:
- UPRU if it only operates UCITS (and other CIS) as a UCITS firm;
 - GENPRU and BIPRU if it also provides investment services under MiFID as a BIPRU investment firm; or
 - IPRU (INV) Chapter 5 if it only operates CIS outside the scope of the UCITS Directive (and IPRU (INV) Chapter 9 also if it is an exempt CAD firm).
- 5.3** The capital requirements of AIFMD and the UCITS Directive are broadly the same, with both being based on funds under management and expenditure and the same types of capital instrument allowed. As we explained in Chapter 4, a firm that is authorised to manage an AIF may also manage UCITS (if it has permission to do so). So we intend to transpose the capital and professional indemnity insurance (PII) requirements of AIFMD alongside those of the UCITS Directive and use common terms to apply to both types of manager, where possible. This means that both UCITS management companies and AIFMs will need to consider the prudential proposals in this paper.

- 5.4** To implement this approach we propose to use the following terms to describe the capital requirements that will be applicable to the resulting types of firm:
- Collective portfolio management firm (CPM firm) – a firm that undertakes external collective portfolio management of AIFs, UCITS or both, but does not provide any MiFID services. This includes what is currently defined as a UCITS firm.
 - Internally managed AIF – an AIF where the legal form permits internal management and where the AIF’s governing body chooses not to appoint an external AIFM.
 - Collective portfolio management investment firm (CPMI firm) – a firm that undertakes external collective portfolio management of AIFs, UCITS or both and provides MiFID services (as permitted by AIFMD and/or the UCITS Directive). This includes what is currently defined as a UCITS investment firm.
- 5.5** This will result in the following changes to the Handbook:
- a new Chapter 7 in IPRU(INV) setting out the requirements for CPM firms and internally managed AIFs;
 - amendments to GENPRU and BIPRU to include the requirements for CPMI firms; and
 - the deletion of UPRU (with the result that UCITS firms will be subject to the requirements of IPRU (INV) Chapter 7²⁸).
- 5.6** Our proposed approach is based on our understanding of AIFMD and the way we implemented the UCITS Directive (on which AIFMD’s capital provisions are largely based). Where relevant we have taken into account the responses we received to DP12/1.²⁹

Initial capital and own funds

- 5.7** AIFMD and the UCITS Directive require firms to meet an initial capital requirement and an own funds requirement. The terms ‘initial capital’ and ‘own funds’ are defined by reference to the CAD. Both are measures of financial resources, but they refer to different combinations of capital items.
- 5.8** The initial capital requirement applies when it is first authorised, but it is not clear how this requirement should apply on an ongoing basis. We propose that the initial capital requirement should be met out of own funds on an ongoing basis. This is consistent with the CAD approach for MiFID investment firms and the way we implemented similar requirements in the UCITS Directive. It is a purposive and proportionate calculation of capital resources, as the own funds calculation better reflects the continuing obligations of the firm (for example it requires the deduction of goodwill). Also, Article 9(3) of AIFMD requires an additional

²⁸ This will be subject to an appropriate transitional period on which we will consult in due course.

²⁹ The responses to questions 18-24 of DP12/1 are taken into account in the proposals in this Chapter.

amount of own funds and we presume this can only be additional to the Article 9(2) requirement which, for this purpose, we therefore interpret as an own funds requirement.

Collective portfolio management firm (CPM firm)

- 5.9** The initial capital requirement for a CPM firm is €125,000³⁰, which as set out above needs to be met out of ‘initial capital’ when the firm is first authorised and out of ‘own funds’ on an ongoing basis. To arrive at the ongoing capital requirement for a CPM firm, a number of elements need to be combined. These are a basic amount (initial capital), a percentage of portfolios under management, an expenditure-based minimum and (where applicable) a capital requirement in respect of professional negligence.
- 5.10** The way in which these elements need to be combined means that a CPM firm has to maintain own funds of at least the higher of the following:
- €125,000; plus 0.02% of the portfolios of UCITS and AIFs under management over €250m³¹; and
 - one quarter of the firm’s relevant fixed expenditure.³²
- 5.11** In addition, a CPM firm that manages AIFs must hold a further amount of own funds and/or PII to cover risks arising from professional negligence³³ (see paragraphs 5.29 to 5.31 for details).
- 5.12** Furthermore, own funds (other than those held to meet the basic €125,000 requirement) must be invested in liquid assets (see paragraphs 5.32 to 5.35 for details).
- 5.13** In due course we will need to take into account the amendments to the CAD that will implement Basel 3.³⁴ It is too early to anticipate these changes in this consultation, but we expect to incorporate any necessary amendments in the Policy Statement.

Internally-managed AIF

- 5.14** AIFMD requires an internally-managed AIF to have initial capital of at least €300,000. This applies when it is first authorised as an internally-managed AIF. Consistent with the approach for a CPM firm, we propose that the initial capital requirement should be met out of own funds on an ongoing basis.

30 Article 9(2) AIFMD or Article 7(1)(a) of the UCITS Directive.

31 Article 9(3) AIFMD or Article 7(1)(a) of the UCITS Directive.

32 Article 9(5) AIFMD or Article 7(1)(a) of the UCITS Directive.

33 Article 9(7) AIFMD.

34 Basel 3 is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the members of the Basel Committee on Banking Supervision in 2010-11. It will be implemented in the EU through amendments to the CAD.

- 5.15** In addition, it must hold own funds or PII to cover risks arising from professional negligence³⁵ and invest any own funds required by Article 9(7) in liquid assets.
- 5.16** AIFMD is not clear on whether the requirements based on either funds under management or expenditure (in Articles 9(3) and 9(5)) apply to internally-managed AIFs. However, we do not propose at present to apply these requirements because this is our understanding of AIFMD's intended policy outcome. This approach is consistent with the requirements of the UCITS Directive on which the capital requirements of AIFMD are largely based.
- 5.17** In DP12/1 we said that we could consider the regulatory regimes in other Member States, which require either the promoter or the internally-managed AIF to hold the capital. Having reviewed the replies, we propose to apply the requirements directly to the AIF, as respondents indicated there is unlikely to be a promoter in the UK.

Q2: Do you agree with our proposed approach to the capital and PII requirements for CPM firms and internally-managed AIFs?

Collective Portfolio Management Investment Firm (CPMI firm)

- 5.18** Article 6(4) of AIFMD allows Member States to authorise an AIFM to provide certain MiFID services. As explained in Chapter 4, we intend to allow this derogation, as we have done for UCITS management companies, so that in addition to managing AIFs an AIFM may manage portfolios of investments and provide certain non-core MiFID services. We propose to define such a firm as a 'CPMI firm' for the purposes of determining its prudential requirements. This term will include what is currently defined as a UCITS investment firm, i.e. a UCITS management company, which carries out the MiFID services that are permitted by Article 6 of the UCITS Directive.
- 5.19** An AIFM that provides MiFID services is required to comply with specified provisions of MiFID.³⁶ We have considered to what extent this means the firm is subject to the CAD and have two options. We could apply the same interpretation as for UCITS investment firms when we implemented the UCITS Directive, meaning an AIFM that provides MiFID services is a BIPRU limited licence firm, but only subject to the pillar 1 requirements of BIPRU for its designated investment business. Alternatively, we could apply the capital requirements of AIFMD only, meaning we would not need to apply the rest of the CAD and would treat an AIFM undertaking MiFID activities in the same way as one that did not undertake such business. Whichever approach we take, the same approach should apply to AIFMs and UCITS management companies.

³⁵ Article 9(7) AIFMD.

³⁶ These provisions include Article 12 of MiFID, which states a firm must have sufficient initial capital in accordance with the CAD, having regard to the nature of its investment business.

- 5.20** Our view is that the first option is the better policy choice and we have drafted the proposed rules on this basis. It is consistent with the UCITS approach and means an AIFM could not undertake discretionary portfolio business without being a BIPRU limited licence firm. It also means that a firm which undertakes these MiFID activities is treated in the same way from a capital perspective, regardless of whether the firm is an AIFM or a MiFID investment firm.
- 5.21** Some respondents to DP12/1 took a different interpretation. They suggested it was not appropriate to apply the CAD in this way and our proposal would require firms to comply with the substantial GENPRU and BIPRU requirements and the connected reporting requirements. However, our analysis indicates a significant number of AIFMs currently also undertake MiFID-scope business as BIPRU limited licence firms.
- 5.22** Our preferred approach means that, as well as meeting the GENPRU and BIPRU requirements for a limited licence firm (with the BIPRU application limited to its designated investment business), the firm must ensure that it meets any additional capital provisions of AIFMD and/or the UCITS Directive. This includes our interpretation that the initial capital requirements of AIFMD and the UCITS Directive should be met by own funds on an ongoing basis (as explained in paragraphs 5.7 and 5.8).
- 5.23** This means that a CPMI firm must maintain own funds that are the higher of the GENPRU and BIPRU requirement for a limited licence firm and the following own funds requirement, which derives from AIFMD or the UCITS Directive (as applicable):
- the higher of: €125,000 plus 0.02% of the portfolios of AIFs and UCITS under management over €250m³⁷ and one quarter of the firm's relevant fixed expenditure³⁸; plus
 - additional own funds and/or PII to cover risks arising from professional negligence³⁹ (see paragraphs 5.29 to 5.31 for details).
- 5.24** Own funds (other than those held to meet the basic €125,000 requirement) must be invested in liquid assets (see paragraphs 5.32 to 5.35 for more details).

Q3: Do you agree that we should treat an AIFM that also undertakes MiFID services as a BIPRU limited licence firm?

The use of a guarantee

- 5.25** Article 9(6) allows a Member State to let an AIFM provide up to 50% of the additional own funds required under Article 9(3) with a guarantee from a credit institution or insurance undertaking.

³⁷ Article 9(3) AIFMD or Article 7(1)(a) of the UCITS Directive.

³⁸ Article 9(5) AIFMD or Article 7(1)(a) of the UCITS Directive.

³⁹ Article 9(7) AIFMD.

- 5.26** We suggested in DP12/1 that we would only include such a provision if firms told us they would use it, as we understood there would be no demand. We also pointed out that, when we implemented similar amendments to the UCITS Directive in 2002, we chose not to incorporate a similar provision based on the responses to our consultation.
- 5.27** There were no replies indicating a clear intention by a firm to use a guarantee. Also, as Article 9(5) requires a firm's own funds never to be less than one quarter of relevant fixed expenditure, the opportunity to use it will be significantly limited. In addition, any guarantee would need to be worded very restrictively to ensure that the funds could be drawn down when required, thereby reducing the availability of suitable guarantors.
- 5.28** We therefore have not included any provision to use a guarantee in the proposed rules, although we will reconsider if firms respond that they would want to use one. We would also be able to consider rule waiver applications from individual firms in this respect against the relevant statutory conditions.

Risks arising from professional negligence

- 5.29** Article 9(7) requires an AIFM to have either own funds or PII to cover potential liability risks arising from professional negligence. The risks that an AIFM must cover and the amounts to be held will be specified in the Level 2 Regulation. These amounts will be based on the AIFs under management, including AIFs managed under delegation, but excluding any UCITS. We expect this Regulation to set out the internal operational risk management policies and procedures the AIFM should implement and we intend to replicate relevant provisions in the Handbook.
- 5.30** We expect that the Level 2 Regulation will allow us to alter, on the basis of the firm's historical loss data, the standard percentage⁴⁰ used in computing the own funds an AIFM must hold. However, we expect that any lower amount will not be allowed to be less than 0.008% of AIFs under management, and that the firm must record at least three years of loss data before any assessment necessary to agree this, and therefore we do not propose to lower the standard percentage. In our view this concession would impose undue costs on both the firm and the FCA⁴¹, which are not warranted by the potential benefit that might be obtained. We expect the Regulation will also allow us to impose a higher percentage on an AIFM, if we are not satisfied that the firm provides sufficient additional own funds to cover appropriately professional liability risks.
- 5.31** We anticipate that some AIFMs will use PII to meet the Article 9(7) requirement. We expect the Level 2 Regulation to specify how the level of PII cover must be computed, both for an individual claim and in aggregate and that any defined excess should be fully covered by additional own funds. However, we do not expect the Regulation to make any reference to

⁴⁰ This is 0.01% of the portfolios of AIFs managed.

⁴¹ The cost to the regulator will be exacerbated because most AIFMs will not be relationship-managed so the necessary work must be done as a separate assignment.

potential policy exclusions so we propose that a firm should maintain adequate own funds to cover any exclusions in the insurance policy.

Liquid assets requirement

- 5.32** Article 9(8) requires own funds to be invested in liquid assets or assets readily convertible to cash in the short term and not in speculative positions. It is clear from AIFMD's wording that the requirement must apply to the own funds required by Articles 9(3), 9(5) and 9(7). We propose not to apply it to any own funds requirement in relation to Articles 9(1) and 9(2) as AIFMD only refers here to initial capital.
- 5.33** We propose that a proportionate interpretation of the term 'assets readily convertible to cash in the short term' is those that could be realised for cash within one month. We have suggested, as guidance, that acceptable assets include cash, readily realisable investments that are not held for short-term resale and debtors. The firm could also include any other assets that fall within the definition, but would need to be able to demonstrate that it could practically realise the relevant asset within one month.
- 5.34** Article 9(10) states that a UCITS management company that manages at least one AIF must also comply with the liquid assets requirement and this will be in respect of its own funds based not only on its AIFs but also on the UCITS that it manages. Although AIFMD does not apply to a UCITS management company that does not manage any AIFs, we propose to apply a liquid assets requirement to such a firm. In our view this is an appropriate and proportionate approach in the circumstances, as the requirement applied to a UCITS management company that manages at least one AIF should be the same as that applied to such a company that manages no AIFs, because the risks addressed by the requirement are the same.
- 5.35** Currently, a UCITS firm is subject to a similar requirement, as Table 2.2.1 in UPRU requires it to deduct illiquid assets in computing its financial resources. As this provision is not required by the UCITS Directive, we propose to remove it. A UCITS investment firm which is subject to GENPRU and BIPRU is currently required either to deduct illiquid assets or material holdings when computing its Pillar 1 capital requirement.

Q4: Do you agree with our proposed approach to professional negligence risks and the liquid assets requirement?

Q5: Do you agree with our intention to apply the liquid assets requirement also to UCITS management companies that do not manage any AIFs?

Financial reporting forms

- 5.36** The proposed amendments outlined above give rise to consequential changes to the SUP 16.12 financial reporting rules and forms and the supporting guidance notes. In particular we propose that the regulated activity of managing an AIF will be classified as regulated activity group (RAG) Number 4.
- 5.37** We propose that a CPM firm should complete a new reporting form, FSA066, which demonstrates whether it meets the capital and PII requirements of IPRU (INV) Chapter 7. It must also complete: FSA029 (balance sheet), FSA030 (income statement), FSA039 (client money and client assets), FSA040 (CFTC) and (if it is a UCITS management company) FSA042 (UCITS) and submit them to us on a quarterly basis within 20 business days.
- 5.38** The firm will also be required to submit the annual report and accounts and solvency statement within 80 business days of the accounting reference date.
- 5.39** We propose that a CPMI firm must complete a new reporting form FSA067 which provides supplementary information, in addition to the other returns currently required from a BIPRU limited licence firm, to demonstrate that the firm complies with the capital and PII requirements that derive from AIFMD.
- 5.40** We will no longer require firms to submit FSA 041 (Asset Managers that use Hedge Fund Techniques Report) as this information will in future be obtained through other reports.
- 5.41** FSA036 (Capital adequacy (for UCITS firms subject to UPRU)) will also no longer be required, as this relates to requirements in UPRU, which is being deleted.

Q6: Do you agree with the proposed changes to SUP 16.12 and that the proposed new forms and guidance notes will provide us with sufficient information to assess whether firms are complying with the capital and PII requirements?

6

Transparency

- 6.1** This chapter covers the Directive's requirements for information to be made available to investors and markets, and to regulators. These relate to information that should be available to investors before an investment decision is made, and on an ongoing basis, the information that must be reported to us.
- 6.2** One of the main objectives of AIFMD is to make it easier for investors and supervisory authorities to assess the risks that AIFMs and AIFs might pose. We propose to introduce rules in the new FUND sourcebook which will transpose Articles 22-24 of the Directive.
- 6.3** The Treasury has indicated that it will use the national discretion granted by the Directive to continue to allow private placement in the UK of AIFs managed by non-EEA AIFMs, provided certain conditions are met.⁴² One of these conditions is that the non-EEA AIFM must comply with similar transparency requirements to authorised AIFMs. So the Treasury is consulting on requiring these AIFMs to comply with Articles 22-24 of the AIFMD.

Disclosure to investors

- 6.4** New rules in FUND 3.2 will transpose the requirements of Article 23 of Level 1, by setting out the information that AIFMs must disclose to investors, for each AIF managed or marketed in the EEA. FUND 3.2 will also refer to the relevant Articles of the Level 2 Regulation that provide more detail on these requirements.
- 6.5** The requirements in FUND 3.2 will apply to UK AIFMs for each EEA AIF they manage and for each AIF they market in the EEA. Under the draft Treasury regulations, non-EEA AIFMs will have to comply with similar requirements for each AIF they market in the UK.

⁴² Article 42 AIFMD.

6.6 The rules set out which information AIFMs must disclose to investors:

- before they invest in an AIF;
- when material changes are made to the information; and
- on an ongoing basis.

Pre-sale disclosure requirements

6.7 The pre-sale disclosure requirements are set out in our draft rules FUND 3.2.2R and 3.2.3R. FUND 3.2.2R requires AIFMs to make a range of information available to investors before they invest in an AIF, including information on an AIF's:

- investment strategy and restrictions;
- use of leverage;
- liquidity risk management arrangements;
- fees and charges;
- valuation procedure;
- net asset value;
- procedure for the issue and sale of units or shares; and
- third-party service provider arrangements.

6.8 This information, and any material changes to it, should be made available to investors in accordance with the constitution of the AIF. This means, at the very least, that the information should be provided to investors on request. Depending on the provisions in the constitution of the AIF, AIFMs may need (for example) to make the information available on a website or proactively inform investors of material changes. Where the fund's constitution does not currently require the information to be made available at least on request, it will need to be amended. In addition, a summary of any material changes to the information must be set out in the AIF's annual report.⁴³ The definition of a material change is expected to be set out in the Level 2 Regulation.

6.9 FUND 3.2.3R also requires AIFMs to inform investors, before they invest in an AIF, of any arrangement made by the AIF's depositary to contractually discharge itself of liability. In addition, the AIFM must inform investors without delay of any changes to the extent of the depositary's liability.

6.10 Many of these disclosure requirements should be familiar to the entities that will become AIFMs managing AIFs marketed to retail investors in the UK, or AIFs subject to the

⁴³ See Article 22(2)(d) AIFMD, transposed in FUND 3.3.4(4)R.

Prospectus Directive.⁴⁴ These requirements may be substantially new for AIFMs managing or marketing AIFs in the UK where the AIFs are unregulated CIS marketed exclusively to professional investors.

Pre-sale disclosure requirements for UK-authorised funds

- 6.11** The Directive allows Member States to continue to impose national requirements on both AIFMs and AIFs where the AIF is marketed to retail investors.⁴⁵ As discussed in DP12/1⁴⁶, the UK currently has national pre-sale investor disclosure rules for authorised AIFs (i.e. NURS and QIS). We do not intend to reconsider our current NURS and QIS disclosure requirements for the purpose of AIFMD implementation. They will continue to apply for the time being, in addition to the standard AIFMD requirements transposed in FUND 3.2. The NURS and QIS disclosure requirements are likely to fall within the scope of the EU Packaged Retail Investment Products (PRIIPs) initiative⁴⁷ and we will need to reconsider them at a later date in light of developments in that area. This approach was supported by the majority of respondents to DP12/1.
- 6.12** We will address in CP2 how best to integrate the AIFMD requirements with the current rules about the contents of NURS and QIS prospectuses.

Ongoing disclosure requirements

- 6.13** The Directive also requires AIFMs managing or marketing AIFs in the EEA to make certain ongoing disclosures to investors. These are transposed in our draft rules FUND 3.2.5R and 3.2.6R. AIFMs must periodically disclose information to investors regarding the liquidity and risk profile of the AIF. AIFMs that manage AIFs employing leverage must disclose, on a regular basis, any changes to the AIF's maximum level of leverage, as well as any right of reuse of collateral or any guarantee granted under the leveraging arrangement.
- 6.14** We expect the Level 2 Regulation to provide further detail on the information to be disclosed and to set out the required frequency of disclosure. It is likely that in most cases the information will have to be disclosed as part of the AIF's periodic reporting to investors and, at a minimum, along with the annual report. However, AIFMs should notify investors immediately if they activate any special liquidity arrangements permitted under the AIF's constitution, such as gates, side pockets or suspensions of redemptions.

⁴⁴ Directive 2003/71/EC.

⁴⁵ Article 43 AIFMD.

⁴⁶ Paragraphs 6.6-6.10 and questions 33 and 34 of DP12/1.

⁴⁷ See the European Commission's *Proposal for a Regulation of the European Parliament and of the Council on key information documents for investment products*, July 2012 http://ec.europa.eu/internal_market/finances-retail/docs/investment_products/20120703-proposal_en.pdf

Annual reporting

- 6.15** The annual reporting requirements in the Directive aim to ensure that investors and regulators are adequately informed about the financial and business affairs and risk profiles of the AIFs that an AIFM manages.
- 6.16** The proposed rules in FUND 3.3 set out the annual reporting requirements for UK-authorised AIFMs.⁴⁸ FUND 3.3 will also refer to the Level 2 Regulation, which will elaborate on these requirements. Under the draft Treasury regulations, non-EEA AIFMs will have to comply with similar requirements for each AIF they market in the UK.

Providing an annual report

- 6.17** Our draft rules FUND 3.3.2R and 3.3.3R will require a full scope UK AIFM to make an annual report available for each UK and EEA AIF it manages and for each AIF it markets in the EEA. A non-EEA AIFM must make an annual report available for each AIF it markets in the UK. The report must be provided to investors on request, and must be made available to us. In the case of an EEA AIF, it must also be made available to the home state competent authority of that AIF.
- 6.18** The report must be provided for each financial year of the AIF and made available no later than six months following the end of the financial year, unless Member States impose a shorter period.⁴⁹ We intend to impose a shorter period on managers of non-UCITS retail schemes to maintain current requirements, which set a maximum of four months after financial year-end for publishing annual reports.⁵⁰

Content of the annual report

- 6.19** Our draft rules FUND 3.3.5R to 3.3.7R set out the minimum areas to be covered in the annual report. As well as the financial statements, they include a report on the AIF's activities during the financial year, any material changes to previous disclosures made to investors, and information on the remuneration of the AIFM's senior management and certain staff members.
- 6.20** We expect the Level 2 Regulation to provide a list of the minimum underlying items that should be included in the report where relevant, without seeking to harmonise the report's contents completely. This approach recognises that different national and international accounting standards will apply to many AIFs. For example, non-EEA AIFs marketed in the UK (under Article 42 AIFMD) will not be subject to UK accounting rules and practices.

⁴⁸ See the European Commission's *Proposal for a Regulation of the European Parliament and of the Council on key information documents for investment products*, July 2012 http://ec.europa.eu/internal_market/financeservices-retail/docs/investment_products/20120703-proposal_en.pdf

⁴⁹ Recital 48 AIFMD.

⁵⁰ COLL 4.5.14R in the Handbook.

- 6.21** The Directive requires the accounting information in the annual report to be audited by an auditor subject to the Audit Directive.⁵¹ However, our draft rule FUND 3.3.6R uses the flexibility in Article 22 of the Directive to allow AIFMs marketing non-EEA AIFs in the UK to have the AIF audited in the country where it is established, provided the process meets international accounting standards.
- 6.22** Currently, managers of UK-authorised funds (i.e. NURS and QIS) are already required to report most of the information required under the AIFMD,⁵² but the remuneration disclosure requirements will be new. We will consult on any necessary changes to align the existing and new requirements for authorised funds in CP2. Managers of unauthorised funds may have to report significantly more information to their professional clients under the new regime than they do now, depending on what disclosures they currently make.

Remuneration disclosure

- 6.23** FUND 3.3.5R will implement the Directive requirement for AIFMs to report the following staff remuneration information:
- the total amount of remuneration for the financial year paid by the AIFM to its staff, split into fixed and variable remuneration; the number of beneficiaries; and, where relevant, carried interest paid by the AIF; and
 - the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.
- 6.24** Most respondents to DP12/1 were supportive of the disclosure requirements.⁵³ Concerns were raised about the risk of compromising confidentiality, particularly with regard to small AIFMs. ESMA has consulted on recommending in its Level 3 guidelines that the remuneration disclosures should be made on a proportionate basis ‘without prejudice to confidentiality’.⁵⁴

Reporting to the FCA

- 6.25** Article 24 AIFMD sets out the information that AIFMs are required to report to competent authorities. These requirements will be transposed in new rules in FUND 3.4.
- 6.26** We expect the Level 2 Regulation to provide more detail on the content, format and frequency of information to be provided, including reporting templates. FUND 3.4 will incorporate some of these requirements where they give more substance to the Level 1

⁵¹ Directive 2006/43/EC.

⁵² COLL 4.5 in the Handbook.

⁵³ Question 35 of DP12/1.

⁵⁴ ESMA's consultation paper ‘Guidelines on sound remuneration policies under AIFMD’, XI Disclosure para 196-197.

requirements. We also intend to incorporate the reporting template in the Level 2 Regulation in SUP 16.

- 6.27** In addition, ESMA intends to develop Level 3 guidelines on a more detailed and harmonised reporting template, which AIFMs can submit to all EU competent authorities. This will be helpful to those AIFMs operating in more than one Member State. We intend to transpose this in SUP 16.
- 6.28** The requirements in FUND 3.4 and SUP 16 will apply to UK-authorised AIFMs for each EEA AIF they manage and each AIF they market in the EEA. Under the draft Treasury regulations, non-EEA AIFMs will have to comply with similar requirements for each AIF they market in the UK.

Current hedge fund data reporting

- 6.29** We currently collect information on the potential systemic risk posed by hedge funds in our Hedge Fund Survey (HFS) and Hedge Fund as Counterparty Survey (HFACS). These surveys are currently voluntary and are conducted on a bi-annual basis. They focus on market dislocations that disrupt liquidity and/or pricing, and losses in hedge funds, which may be transmitted to counterparties.
- 6.30** Some firms currently submitting data as part of these surveys are likely to become AIFMs and will need to comply with the AIFMD reporting requirements. They will be reporting much of the same data but the format and some of the details will change. Smaller hedge fund managers, like all other AIFMs that do not participate in the survey, will see a more significant change in their reporting obligations under AIFMD. The precise impact of these changes will become clearer once the Level 2 Regulation and ESMA's Level 3 guidelines are finalised.
- 6.31** Since much of the data we ask for in the HFS will need to be reported under the AIFMD, we do not intend to continue to collect data through the HFS. We will continue to run the HFACS, on a voluntary basis, as this captures useful information from hedge fund counterparties that will not need to be reported under the AIFMD.

General reporting requirements

- 6.32** Our draft rules FUND 3.4.2R and 3.4.4R will require AIFMs to report regularly to the FCA on:
- the main markets and instruments in which they are trading;
 - the principal exposures of each AIF they manage;
 - their risk and liquidity management systems; and
 - the results of their stress tests.

- 6.33** The required frequency of reporting will be set out in the Level 2 Regulation and is likely to depend on the size and type of funds managed by the AIFM. We expect that the first reporting deadline will be October 2013 and will apply to certain AIFMs authorised after 22 July 2013, where those AIFMs manage portfolios of AIFs whose assets total more than €1 billion, or manage an individual AIF whose assets total more than €500m. It will not apply to AIFMs operating under transitional provisions as set out in Chapter 2.
- 6.34** In addition, AIFMs must provide the FCA on request with an annual report for each AIF they manage or market in the EEA and a detailed list each quarter of all the AIFs they manage.

AIFMs employing substantial leverage

- 6.35** An AIFM managing an AIF that employs leverage on a substantial basis must report additional information to the FCA on the level and type of leverage used, as well as on the source of funding for the leverage. We expect the Level 2 Regulation to define the use of leverage on a ‘substantial’ basis.

Capital reporting by AIFMs

- 6.36** In addition to reporting information about the AIFs they manage under Article 24, we intend to require AIFMs to report information for their capital requirements and the amount of capital they hold. These requirements will be set out in SUP 16 Annex 24R. They are explained in paragraphs 5.36 to 5.41 on prudential requirements.

Additional reporting

- 6.37** The reporting rules aim to make it easier for regulators to identify, assess, monitor and manage systemic risk effectively. The FCA will be given the power to require AIFMs to report additional information on a ‘periodic’ or ‘ad hoc’ basis where necessary for it to manage systemic risk. We are currently considering in what circumstances we may require AIFMs to report additional information to us and will provide an update on this in due course. In exceptional circumstances, ESMA will have the power to ask the FCA and other competent authorities to impose additional reporting requirements on AIFMs that must report under the rules of FUND 3.4.

Operational aspects of reporting

- 6.38** To comply with FUND 3.7.8R, AIFMs will need to inform the FCA of any changes in the leverage limits of the AIFs they manage. In DP12/1 we asked respondents for their views on the best way to report this to us.⁵⁵ Responses were mixed, with some favouring a written notification and others preferring an online platform. We are updating our systems to take

⁵⁵ Question 16 DP12/1.

account of the new data that firms will need to report to the FCA and expect to provide an update in due course on how firms will need to report.

- 6.39** In DP12/1 we noted that non-EEA AIFMs marketing AIFs in the UK will also have to report to the FCA and asked for respondents' views on the most practical way for them to do this.⁵⁶ Most respondents either suggested that ESMA should develop a standardised reporting form or that the FCA should rely on the reports that non-EEA AIFMs provide to their national regulator. There was no clear consensus on which of these would work better. The reporting templates that ESMA is developing will capture non-EEA AIFMs and will provide consistency in reporting obligations across Member States. So we expect that non-EEA AIFMs will report to the FCA after 22 July 2013 using the same systems as UK AIFMs.

⁵⁶ Question 37 in DP12/1.

7

Operating requirements for AIFMs

- 7.1** This chapter outlines the requirements of the Directive that are applicable to the operation of AIFMs. These include fair treatment of investors, conflicts of interest management, organisational requirements, and risk, delegation, and remuneration requirements.
- 7.2** Respondents to DP12/1 stressed the need for consistency between the operational requirements in the AIFMD and those in the UCITS and MiFID Directives.⁵⁷ The organisational requirements in the AIFMD are designed to be broadly consistent with the principles and requirements in the UCITS and MiFID Directives, while at the same time seeking to take into account the particular characteristics of different types of AIF and the diverse assets in which they may be invested.
- 7.3** Most of the organisational requirements in the Level 1 Directive are aligned with those in the UCITS Directive, so we believe that there will not be many significant differences for firms seeking dual authorisation. MiFID firms becoming AIFMs should already be compliant with most of the general and resources requirements, the rules setting out whether AIFMs might need to have a separate compliance or a permanent internal audit function, and the rules on personal transactions.
- 7.4** MiFID firms are currently subject to the risk management requirements in SYSC 7.1, which cover similar areas to the draft rules for AIFMD risk requirements. However, in some areas, the AIFMD introduces new or more stringent requirements, such as setting maximum leverage limits. MiFID firms becoming AIFMs will need to review their current leverage policies, as well as their current risk-management arrangements more generally, against the AIFMD requirements, to ensure that they are able to comply.
- 7.5** UCITS management companies are currently subject to the risk management requirements in COLL 6.11 as well as to Handbook guidance in SYSC 7.1. Where AIFMD introduces differences, firms intending to seek dual authorisation will need to ensure that they still

⁵⁷ Question 12 in DP12/1.

comply with the UCITS standards in relation to their UCITS business and that their AIFM business is compliant with the AIFMD requirements.

General principles

- 7.6** Article 12 AIFMD sets out a number of overarching principles of conduct for full scope UK AIFMs and incoming EEA-authorised AIFMs operating from a branch in the UK. Firms that are currently UCITS management companies or MiFID investment firms will be broadly familiar with the principles which underpin these requirements. Where there are elements specific to AIFMD, we propose to add new rules or amend existing rules.
- 7.7** The Level 2 Regulation is expected to set out the minimum criteria for assessing an AIFM's compliance with Article 12(1). These should include requirements for due diligence, dealing on behalf of the AIF and handling subscription or redemption orders.
- 7.8** Some of the provisions in Article 12 summarise requirements set out in subsequent articles of the AIFMD. So we intend to transpose these requirements in the parts of the Handbook that deal with the area in question. For example, we propose to amend SYSC 4.1.2CR to transpose Article 12(1)(c) on resources and procedures, along with similar requirements in Article 18.
- 7.9** Examples of proposed new rules are:
- COBS 2.1.4R, which transposes the fair treatment and conduct of business requirements in Article 12(1);
 - SYSC 10.1.22R, which transposes Article 12(2)(a) on conflicts of interest for AIFMs conducting discretionary portfolio management; and
 - SYSC 10.1.23R, which transposes Articles 12(1)(d) and article 14 on conflicts of interest requirements.

Fair treatment

- 7.10** The AIFMD aims to promote the fair treatment of investors and enhance investor protection.
- 7.11** Currently-authorised firms are already subject to Handbook Principle 6: a firm must pay due regard to the interests of its customers and treat them fairly. We issued guidance in 2007/8 on what fair treatment of retail customers under the Principles means for managers of CIS.⁵⁸
- 7.12** The proposed rule COBS 2.1.4R will require authorised AIFMs to treat all AIF investors fairly and to ensure that no investor in an AIF should get preferential treatment unless this

⁵⁸ PS07/11: *Responsibilities of Providers and Distributors for the fair treatment of customers – Feedback on DP06/4 and Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers*, January 2008.

has been disclosed in the relevant AIF's constitutional documentation.⁵⁹ This covers similar ground to Principle 6 and is an example of an AIFMD-specific rule addressing an area where the Handbook Principles and rules currently apply more generically to authorised firms. However, it provides more detail on the circumstances in which an AIFM can give preferential treatment to an AIF investor.

- 7.13** Examples of preferential treatment include reduced fees, better access to portfolio data or preferential terms in relation to side pockets. Such preferential treatment might, for example, be granted to 'seed' investors to compensate them for the risks they have taken. Respondents to DP12/1 also suggested that fair treatment of investors might include disclosing side letters to all AIF investors and ensuring that the preferential terms given to one investor are available to other investors in a similar position.⁶⁰ We expect the Level 2 Regulation when adopted to contain more detailed requirements on fair treatment.
- 7.14** Most respondents to DP12/1 agreed that the broad principle of fair treatment should apply to professional investors in the same way as to retail investors.⁶¹ However, respondents noted that professional investors may be more inclined to negotiate their own terms of investment rather than buying standardised units or shares in a scheme. It would therefore be more common to see professional investors treated differently from each other than would be the case with retail investors. This is not inconsistent with the requirements of the Directive, as long as the terms agreed with investors are adequately disclosed and do not result in overall material disadvantage to other investors.
- 7.15** The recently published *Journey to the FCA*⁶² envisages a more interventionist approach to supervising conduct in the wholesale markets, noting that wholesale misconduct can undermine market integrity and indirectly affect retail consumers. Our approach to supervising the fair treatment of professional AIF investors will reflect this. While we recognise that professional investors have a greater understanding of sophisticated financial products than retail investors, firms will need to ensure that they have high standards of conduct in their dealings with all investors.

Conflicts of interests

- 7.16** The Directive requires firms to put in place organisational and administrative arrangements to identify, prevent, manage and monitor conflicts of interest. The rules transposing these governance requirements⁶³ appear in SYSC 10.1 along with the conflicts of interest requirements for other types of authorised firm. It is intended that SYSC 10.1 will refer to the relevant articles of the Level 2 Regulation, which we expect to contain

⁵⁹ Article 12(1) AIFMD.

⁶⁰ Question 5 in DP12/1.

⁶¹ Question 6 in DP12/1.

⁶² p31, *Journey to the FCA*, October 2012.

⁶³ Set out in Articles 14 and 12(1)(d) AIFMD.

more detailed requirements on identifying, preventing, managing, monitoring and disclosing conflicts of interest.

Identifying conflicts of interest

- 7.17** An AIFM must take all reasonable steps to avoid conflicts of interest and prevent them from adversely affecting the interests of the AIFs and their investors. In particular, the AIFM must identify potential conflicts between the following parties:
- the AIFM, and an AIF managed by the AIFM or the investors in that AIF;
 - an AIF or the investors in that AIF, and another AIF, or the investors in that other AIF;
 - an AIF or the investors in that AIF, and another client of the AIFM;
 - an AIF or the investors in that AIF, and a UCITS managed by the AIFM or the investors in that UCITS; or
 - two clients of the AIFM.⁶⁴
- 7.18** Such conflicts should be managed, monitored or, where applicable, disclosed where they can no longer be avoided.⁶⁵

Arrangements to minimise conflicts of interest

- 7.19** AIFMs must operate organisational and administrative arrangements for managing and monitoring conflicts, segregate operational tasks and responsibilities that may generate conflicts, and assess whether their operating conditions involve any other material conflicts.⁶⁶
- 7.20** Where an AIFM's arrangements prove not to be sufficient to prevent the risks of damage to investors, it must disclose any conflicts to investors before undertaking business on their behalf, and develop appropriate policies going forward.⁶⁷

Prime brokers

- 7.21** When the services of a prime broker are used, the AIFM must exercise due skill and care in selecting and appointing the prime broker. The prime brokerage agreement must be subject to a written contract, including whether re-use of AIF assets is allowed, and the AIF depositary must be informed of the contract.⁶⁸ The rules relating to prime brokers are transposed in FUND 3.8. We have separated these from the other conflicts of interest requirements in the Handbook because they relate specifically to an AIFM's relationship with its prime broker.

⁶⁴ Article 14(1) AIFMD and draft SYSC 10.1.22R.

⁶⁵ Article 12(1) AIFMD and draft SYSC 10.1.23R.

⁶⁶ Article 14(1) AIFMD and draft SYSC 10.1.24R.

⁶⁷ Article 14(2) AIFMD and draft SYSC 10.1.25R.

⁶⁸ Article 14(3) AIFMD and draft SYSC 10.1.25R.

Changes for MiFID/UCITS firms

- 7.22** The AIFMD conflicts of interest requirements are broadly similar to those already applying to MiFID firms and UCITS management companies. However, the requirements for prime brokers will be new for all full scope UK AIFMs.

Compensation

- 7.23** Article 12(2)(b) of AIFMD refers to the scope of a Member State's compensation scheme. We will consult on the application of the Financial Services Compensation Scheme to firms affected by AIFMD in CP2.

Organisational requirements

- 7.24** AIFMD aims to ensure that AIFMs operate under robust governance controls and are organised and managed to minimise conflicts of interest between the AIFM and its clients, including AIFs and AIF investors.
- 7.25** Article 18 of the Level 1 Directive sets out the general principles according to which an authorised AIFM must organise itself effectively. These will be informed by more detailed requirements in the Level 2 Regulation.
- 7.26** We intend to transpose the Article 18 requirements by integrating them into the existing text in SYSC 4.1. This section of SYSC contains general organisational requirements that apply to most authorised firms, including many of those that will become AIFMs.
- 7.27** The new rules will require AIFMs to use, at all times, adequate and appropriate human and technical resources necessary for the proper management of AIFs. To ensure this, AIFMs must put appropriate controls and procedures in place, including:
- rules for personal transactions and transactions on the firm's account;
 - sound administrative and accounting procedures; and
 - controls and safeguard arrangements for information processing systems.
- 7.28** In considering what constitutes appropriate human and technical resources for a given AIFM, the FCA will expect the AIFM to take into account the nature, scale and complexity of its business and the types of AIFs under its management in a way which is proportionate. In supervising these requirements, we will expect firms to be able to justify to us the approach they have taken.
- 7.29** The general organisational requirements closely match those that apply to UCITS management companies and are similar to many of the requirements applying to MiFID

firms. MiFID firms becoming AIFMs will need to check their compliance with the rules on the responsibilities of the governing body, accounting, electronic data processing and record-keeping.

Compliance function

- 7.30** We expect that the Level 2 Regulation will require an AIFM to establish a permanent and independent compliance function commensurate with the size of its business and the types of AIF it manages. We expect that any such requirements will be similar to those contained in the MiFID and UCITS Directives. Such requirements are likely to be new for many other CIS operators becoming AIFMs.
- 7.31** Respondents to DP12/1 suggested that the following factors should be considered in deciding whether it would be disproportionate to have a separate compliance function:
- the number of employees in the AIFM;
 - the number, size and type of funds under the AIFM's management;
 - the number and type of investors;
 - the complexity of the AIFM's business model;
 - whether the AIFM is part of a larger group with a group compliance function;
 - the extent of leverage in the AIFs;
 - the volume of transactions;
 - whether the AIFM operates across several jurisdictions;
 - the degree of outsourcing; and
 - whether the AIFM may hold client money.⁶⁹
- 7.32** It remains to be seen whether the Level 2 Regulation permits a firm not to maintain a separate compliance function.

Internal audit function

- 7.33** Respondents to DP/1 suggested that, in deciding whether an AIFM should have a permanent internal audit function, similar factors should be taken into account, as in the decision of whether to have a separate compliance function. One respondent suggested that an AIFM would need a separate compliance function before it needed a permanent internal audit function.

⁶⁹ Question 11 in DP12/1.

- 7.34** Whether an AIFM will also be required to establish an independent and separate internal audit function will be determined by the requirements of the final Level 2 Regulation.
- 7.35** We expect that any such requirements will be similar to those contained in the MiFID and UCITS Directives. Such requirements are likely to be new for many other CIS operators becoming AIFMs.

Risk management

- 7.36** The Directive applies a number of risk management provisions to a full scope UK AIFM. Their aim is to mitigate appropriately the risks inherent in the AIFM's business, by ensuring that its risk management function operates independently and effectively. The requirements will be informed by more detailed provisions in the Level 2 Regulation, including expected requirements to maintain a permanent risk management function, to implement an appropriate risk management policy and to put in place effective risk management systems.
- 7.37** The risk management requirements in the Directive are transposed in FUND 3.7, which applies to all full scope UK AIFMs. It is intended that FUND 3.7 will incorporate some of the Level 2 requirements where these substantially clarify how AIFMs should interpret the Level 1 Directive.

Functional and hierarchical separation of the risk management function

- 7.38** FUND 3.7.2R requires AIFMs to separate their risk management function functionally and hierarchically from their operating units, including the portfolio management function. It is intended that FUND 3.7.3EU will reproduce the relevant requirements from the Level 2 Regulation. We expect this to set out the conditions under which we will consider this requirement to be met.
- 7.39** Respondents to DP12/1 suggested that the structural and functional splits required by the AIFMD would impact private equity firm structures disproportionately.⁷⁰ While there cannot be different treatment for private equity AIFMs, we are required to apply the principle of proportionality when reviewing an AIFM's compliance with this rule. We will take account of each firm's structure in supervising the requirements.
- 7.40** The AIFM must, as a minimum standard, be able to demonstrate that specific safeguards against conflicts of interest are in place to allow for independent risk management, and that the risk management process is consistently effective. It is intended that FUND 3.7.4EU will incorporate requirements in the Level 2 Regulation specifying that these safeguards must at least include:
- using reliable and appropriately controlled data;

⁷⁰ Question 7 of DP12/1.

- remunerating risk management staff in accordance with the performance of the risk management function, independently from the performance of the other business areas in which they are engaged;
- independent decision-making;
- the same degree of authority for the risk management and portfolio management functions; and
- segregating conflicting duties.

7.41 We expect the Level 2 Regulation to require an AIFM's governing body to review regularly the effectiveness of any such safeguards and take timely remedial action to address any deficiencies.

7.42 Some responses to DP12/1 noted that the requirements for the functional and hierarchical separation of the risk management function could present challenges for smaller fund managers and those managing private equity, venture capital and property funds.⁷¹ In assessing the efficacy of risk management practices and controls, the FCA will take account of any such safeguards used by an AIFM.

Risk management systems

7.43 FUND 3.7.5R and 3.7.6R will transpose the Level 1 requirements⁷² for AIFMs to implement adequate risk management systems to identify, measure, manage and monitor appropriately all risks relevant to each AIF's investment strategy and to which each AIF is or may be exposed. We would expect these systems to include at least an appropriate due diligence process when investing on behalf of the AIF, appropriate stress-testing procedures, and a process to ensure that the AIF's risk profile corresponds to its size, portfolio structure, investment strategies and objectives.

7.44 We expect that the Level 2 Regulation will specify the appropriate frequency at which any such reviews must be undertaken by an AIFM, and the circumstances that might trigger a review by an AIFM. For example, a review will be required where material changes are made to the risk management policies and procedures or the investment strategy and objectives of the AIF.

Risk limits

7.45 In DP12/1 we asked why use of qualitative risk limits might be in the interests of AIF investors. Respondents cited examples of where qualitative risk limits might be more informative than quantitative limits, for example where assets are illiquid or hard to value.⁷³

⁷¹ Question 13 of DP12/1.

⁷² Article 15(2) AIFMD.

⁷³ Question 14 of DP12/1.

- 7.46** The Level 2 Regulation is expected to require an AIFM, as part of its risk management systems, to establish and implement quantitative and/or qualitative risk limits for each AIF it manages. We expect these risk limits will need to be aligned with the risk profile of each AIF as disclosed to investors under FUND 3.2.5R. The limits must take into account all relevant risks, and at least those risks set out in the Level 2 Regulation.
- 7.47** Where an AIFM sets purely qualitative limits, we would expect it to justify this approach to us. As noted in DP12/1, this justification might include the reasons why it would be difficult to set meaningful quantitative risk limits or why using quantitative risk limits might not be in the best interests of the AIF's investors. We think that in setting only qualitative risk limits, the intention of the AIFM should not be to seek additional flexibility to take on more risk with the aim of increasing the potential investment returns.

AIFMs managing leverage risk

- 7.48** The Directive requires an AIFM to set a maximum level of leverage for each AIF under management. Our draft rules in FUND 3.7 will transpose what will be new requirements for AIFMs using leverage in the funds they manage. FUND 3.7.7R will require the AIFM to set out the extent to which its leveraging arrangements give the prime broker (or other counterparty) the right to re-use the collateral or grant a guarantee. In doing this it must take account of certain considerations, including the investment strategy of the AIF, the sources of leverage and systemic risk implications.
- 7.49** FUND 3.7.8R requires AIFMs to demonstrate to the FCA that the leverage limits of each AIF are reasonable and that they comply with those limits at all times. We explain this further in paragraphs 8.2.4 and 8.2.5.
- 7.50** An AIFM making changes to the maximum level of leverage must in future disclose this to investors (FUND 3.2.6R). In DP12/1 we asked respondents what constituted a 'material change' for the purpose of this rule.⁷⁴ However, we now expect the Level 2 Regulation to stipulate that this applies to all changes to the maximum level of leverage.
- 7.51** Respondents to DP12/1 also asked whether AIFMs had to disclose the information before or after making the change and whether they had to obtain prior approval from investors. The Level 2 Regulation is expected to require the information to be provided without undue delay. This gives AIFMs the flexibility to change the maximum level of leverage without prior communication, but ensures that investors will be informed on a timely basis. Any stricter notification or approval requirements in an AIF's prospectus should still be adhered to, and specific rules for NURS and QIS will continue to apply.

⁷⁴ Question 15 DP 12/1.

Delegation

Delegation by authorised AIFMs

- 7.52** The Directive aims to ensure that, where AIFMs delegate their AIFM functions, they only do so subject to certain conditions.⁷⁵ In order to ensure they are compliant with our new rules, AIFMs will need to review their current delegation arrangements against the criteria mentioned below, whether the delegation is done intra-group or involves independent third parties.
- 7.53** Where the AIFM proposes to delegate any investment management function to a firm outside the EEA, it must in future obtain prior approval from us if that firm is not authorised or registered in its jurisdiction and is not subject to supervision.
- 7.54** We intend to transpose delegation requirements in FUND 3.10. These new rules will require AIFMs to notify us of the proposed delegation before the arrangements take effect.⁷⁶ The arrangements must, for example, meet conditions such as:
- the entire delegation structure is justifiable on objective reasons;
 - the proposed delegate has sufficient resources, and is properly qualified;
 - the delegate performing investment management functions is authorised or registered, and subject to supervision⁷⁷; and
 - in cases where the delegate is located outside the EEA, there is cooperation between the FSA and the delegate's supervisory authority.
- 7.55** The functions covered by the delegation provisions are specified in the Directive. We propose to add the defined term 'AIFM management functions' to the Glossary to cover this concept.
- 7.56** The Directive also contains rules on sub-delegation and restriction on delegating functions to the depositary or where there may be a conflict of interest with the AIFM or the AIF. We intend to transpose these requirements in FUND 3.10.4R to 3.10.6R.
- 7.57** The Level 1 requirements will be supplemented by more detailed requirements in the Level 2 Regulation. We expect it to require that the proposed delegation arrangements be subject to a written agreement, and that the delegate has proper business continuity planning.

Supervisory cooperation arrangements with non-EEA authorities

- 7.58** Cooperation between the FCA and the supervisory authorities of a jurisdiction where a non-EEA delegate is located will be ensured when we have signed a cooperation

⁷⁵ Article 20 AIFMD.

⁷⁶ FUND 3.10.2R.

⁷⁷ The Directive also allows an exemption from this condition with the prior approval of the competent authorities of the home Member State of the AIFM. Article 20(1)(c). This exemption will be transposed by the Treasury.

arrangement with the relevant supervisory authority. ESMA on behalf of EU competent authorities is currently negotiating these cooperation arrangements with non-EEA supervisory authorities. Further details of the agreed cooperation arrangements will be available as we get closer to the AIFMD implementation date. For AIFMs delegating portfolio management or risk management outside the EEA, it will be necessary to confirm that a cooperation arrangement is in place with the jurisdiction of the delegate. This information will be publicly available on a website. We will communicate details of the location in due course.

‘Letterbox entity’

- 7.59** The Level 1 Directive specifies that an AIFM must not delegate its functions to the extent that it can no longer be considered to be the manager of the AIF, but will instead be considered by its competent authority to have become a ‘letterbox entity’.⁷⁸ The Level 2 Regulation is likely to specify in considerably more detail the considerations we should take into account when we assess whether a ‘letterbox entity’ would result from an AIFM’s proposed delegation arrangements. The Commission may impose requirements additional to those advised by ESMA in its technical advice.⁷⁹
- 7.60** At the time of publishing this paper, we cannot say with any legal certainty how we might assess a proposed delegation. We have nonetheless been considering the line at which appropriate delegation should be drawn to avoid an improper delegation by an AIFM to a delegate entity, whether that entity is within the internal market or offshore.
- 7.61** Delegation can be a means of stimulating competition in the UK and the internal market; it can assist new market entrants to establish viable operating models, thereby reducing barriers to entry. There are also significant benefits for investors when delegation is carried on effectively and responsibly. Delegation can enable experts in a particular field to market their services widely and raise standards, lowering costs and achieving economies of scale. AIFMs can deliver additional benefits to AIF investors by importing this knowledge and skills through delegation – for example, in specialist risk measurement and monitoring – which not all AIFMs can replicate in-house. This principle of delegating a task or service to specialist providers to achieve a better standard or source expertise is specifically recognised elsewhere in the Directive.⁸⁰
- 7.62** We intend to assess any delegation arrangements on a case-by-case basis in a robust and flexible way, while taking account also of the Level 1 and Level 2 requirements. We envisage taking into account the following non-exhaustive factors:
- the ‘objective reasons’ in FUND 3.10.2R;
 - the AIFM and AIF operating models, and the types of assets under management;

⁷⁸ Recital 83 and Article 20(3) AIFMD.

⁷⁹ Box 74 of ESMA’s advice.

⁸⁰ For example, the valuation provisions in Article 19 where an external valuer may be appointed by the AIFM. Appointment of an external valuer may be appropriate for certain types of AIF under management.

- the activities being carried on by the entities concerned, whether intra-group or with third party delegates;
- the nature of the decision-making among the connected entities being reviewed. This means that the judgments made by an AIFM on the core activities of portfolio and risk management are genuine rather than a show of compliance⁸¹;
- that regular and effective oversight of the delegate is undertaken by the AIFM; and
- that different considerations might apply to each type of AIF.⁸²

7.63 We envisage that the assessment of a ‘letterbox entity’ should principally be a qualitative rather than a quantitative test. We hope that the Level 2 Regulation has been issued or adopted by the time of publication of our second AIFMD consultation. At that time, given that the more detailed requirements for delegation will be settled, we will give firms a further steer as to how we will exercise our supervisory judgement in relation to proposed delegation arrangements and what factors might result in an AIFM becoming a ‘letterbox entity’.

Remuneration

7.64 One of the aims of the Directive is to bring asset managers into line with recent regulatory developments in Europe applying rules to the remuneration of key staff. Banks and MiFID firms are already subject to our Remuneration Code (SYSC 19A), which implements relevant EU legislation.⁸³ The new AIFMD remuneration rules will, however, take into account the specificities of the asset management sector.

7.65 The Directive requires ESMA to issue guidelines on sound remuneration policies, which comply with Annex II of AIFMD.⁸⁴ On 28 June 2012, ESMA published a Consultation Paper⁸⁵ containing draft guidelines on sound remuneration policies under the AIFMD. We expect the final text of these guidelines to be published in Q1 2013.

Remuneration principles

7.66 We intend to transpose the AIFMD remuneration rules and principles⁸⁶ in SYSC 19B of the Handbook.

⁸¹ The Level 1 Directive and Level 2 Regulation, read together, will impose standards of good corporate governance on the governing body of the AIFM. As well as the obvious principles of honesty, integrity and fairness, there is reference to the need for directors to commit sufficient time to their duties, and for them to demonstrate independence of mind in assessing and challenging the information reported to them. These are very important tests and the Weaving judgement of the Grand Court of Cayman (delivered in August 2011, after the development of ESMA’s draft advice on the ‘letterbox entity’ test) found against the directors of a fund because they did not challenge, but rubber-stamped, whatever was presented to them. The Weaving judgement is not binding in UK law but is relevant to how supervisors in EEA and non-EEA jurisdictions cooperate for the purposes of AIFMD.

⁸² In accordance with the principle embedded in the Level 1 Directive and the draft Level 2 Regulation, AIFMD also recognises the diversity of AIFs that can be managed with the result that certain Directive provisions have a differentiated application. For example, unleveraged closed-ended AIFs are not subject to liquidity management requirements. Likewise, AIFMs which do not use leverage for AIFs under their management are not subject to Article 25(3).

⁸³ CRD3 and the CEBS Guidelines on Remuneration Policies and Practices.

⁸⁴ Article 13(2) AIFMD.

⁸⁵ See www.esma.europa.eu/consultation/Consultation-Guidelines-sound-remuneration-policies-under-AIFMD.

⁸⁶ Article 13 and Annex II of AIFMD.

7.67 AIFMs will be required to have remuneration policies that promote effective risk management, while at the same time allowing risk-taking commensurate with each AIF's investment objectives.⁸⁷ These remuneration policies will need to apply to staff whose professional activities have a material impact on the risk profiles of the AIFM or the AIFs under management. These staff categories will include senior management, risk takers, control functions and any employees who receive total remuneration, taking them into the same remuneration bracket as senior management and risk takers.⁸⁸

7.68 AIFM remuneration policies will need to cover elements such as:

- performance-related pay;
- guaranteed variable remuneration;
- balance between fixed and variable components of total remuneration;
- remuneration in the form of units and shares in the AIFs under management;
- a mandatory deferral period of at least three to five years, unless the life cycle of the AIF is shorter; and
- clawback of remuneration for under-performance.

Proportionality

7.69 The Directive states that the remuneration principles will apply to AIFMs 'in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities'.

7.70 Several respondents to DP12/1 asked how proportionality would apply to an AIFM's remuneration policy, and whether there would be differences with the proportionality framework in our existing Remuneration Code.⁸⁹ In certain circumstances AIFMs may be subject to both AIFMD and the Remuneration Code. Respondents to DP12/1 identified this potential overlap as an area of concern because of the likelihood of increased administrative burdens and the difficulties of adopting a group-wide policy that complies with both regimes insofar as they may diverge.

7.71 The extent to which proportionality may be applied to an AIFM's remuneration policies is still being considered by ESMA. Once the ESMA guidelines are finalised, we intend to establish a proportionality framework specific to firms within the scope of AIFMD, incorporating European requirements and guidelines. The framework for AIFMs will take account of the Remuneration Code in SYSC 19A, but is likely to differ from it in structure.

⁸⁷ SYSC 19B.1.2R. See Article 13(1) AIFMD.

⁸⁸ SYSC 19B.1.3R. See Article 13(1) AIFMD.

⁸⁹ Question 9 of DP12/1.

AIFM subsidiary of a credit institution

- 7.72** A number of subsidiaries within banking groups conduct AIFM business. At present, all entities within these banking groups, including these AIFM subsidiaries, are subject to the Remuneration Code.
- 7.73** Under the Remuneration Code's 'group principle', the starting position is that all subsidiaries of a banking group are in the same proportionality level as the highest level entity in the group. However, there is a procedure whereby asset management subsidiaries can obtain individual guidance, allowing them to move down to a lower proportionality level on a solo basis if doing so is justifiable on prudential grounds. A number of firms have obtained individual guidance for their asset management subsidiaries.
- 7.74** The Directive does not address the issue of how to deal with overlapping remuneration regimes. The relevant group might be expected to apply the Remuneration Code's principles to credit institutions and any MiFID investment firms which are not also AIFMs in the group, and the AIFMD remuneration requirements to any AIFM subsidiaries.
- 7.75** AIFM subsidiaries within a group will remain subject to the AIFMD rules and SYSC 19A (and subject to any permissible disapplications of specific requirements on proportionality grounds). However, application of the AIFMD remuneration provisions should satisfy compliance with SYSC 19A in the first instance insofar as the AIFMD provisions are deemed to be equivalent to the CRD3 provisions. We have included a guidance provision to this effect in SYSC 19A.1.1AG.

AIFMs carrying on MiFID investment activities

- 7.76** As explained in paragraph 4.17 to 4.19, we expect that AIFMs currently doing certain types of MiFID investment business are likely to continue doing investment business under an AIFM authorisation.⁹⁰ Such AIFMs will be defined in the Glossary as an 'AIFM investment firm', which is a type of 'Collective Portfolio Management Investment Firm'.
- 7.77** Most MiFID investment firms currently fall under 'level 3' of the Remuneration Code, (formerly described as Tier 3 or 4).⁹¹ As a result, they are able to disapply a number of requirements in the Code, such as those relating to deferral.
- 7.78** We consider that the Directive should be read as requiring us to apply both sets of requirements to AIFMs performing MiFID investment business. The Directive applies certain articles of MiFID, such as those relating to organisational requirements and conduct of business obligations to the provision of MiFID investment services by an AIFM.⁹² However, our preferred option is that where an AIFM investment firm complies with AIFMD's remuneration rules, that compliance will satisfy the requirements of the Code.

⁹⁰ Article 6(4) AIFMD.

⁹¹ The proportionality guidance for the Remuneration Code is available here: www.fsa.gov.uk/library/policy/final_guides/2012/fg1219

⁹² Article 6(6) AIFMD. Article 13 of MiFID relates to organisational requirements and Article 19 relates to conduct of business obligations when providing investment services to clients.

- 7.79** Depending on how we implement proportionality for the AIFMD regime in the UK, larger, more complex AIFM investment firms may end up having to comply with more requirements than has so far been the case under the Code.
- 7.80** We have included this proposed requirement in consequential changes to BIPRU, which effectively treat AIFM investment firms as BIPRU investment firms in the Handbook and thus subject to the Remuneration Code.⁹³ Additionally, a new guidance provision in the Code clarifies the treatment of AIFM investment firms.⁹⁴

Q7: Do you agree with our proposal for aligning the existing requirements under the FSA Remuneration Code with the new AIFMD remuneration rules? Do you have any specific concerns regarding:

- Our proposed treatment of AIFMs which are part of a banking group?
- AIFMs doing MiFID investment business?

⁹³ See revisions to GENPRU and BIPRU integrating AIFM Investment Firms.

⁹⁴ SYSC 19A.1.1AG.

8

Management requirements for AIFMs

- 8.1** This chapter covers requirements on AIFMs relating to valuation of an AIF's assets, including the use of an external valuer, management of liquidity within the AIF's portfolios, and use of leverage by AIFMs for AIFs under management.

Valuation

- 8.2** AIFMs will be required to put appropriate and consistent procedures in place for the proper and independent valuation of the assets of each AIF they manage. Also, the net asset value (NAV) per unit or share of each AIF must be calculated and disclosed to investors at least once a year. These requirements are transposed in FUND 3.9 and should be incorporated into the constitutional documents of the AIF.
- 8.3** The Level 2 Regulation is expected to contain further information on the valuation procedures that AIFMs must put in place. For example, it is likely that AIFMs will be required to undertake periodic reviews of the valuation methodologies and the valuation of individual assets where a material risk of inappropriate valuation might arise.

Appointment of an external valuer

- 8.4** FUND 3.9.7R will require an AIFM to carry out the valuation of the AIF itself or appoint an external valuer. If an AIFM opts for an external valuer to perform the function, the AIFM will be required to notify us of this appointment. The AIFM must demonstrate that the external valuer is professionally registered and subject to legal or regulatory provisions or professional conduct rules, and that the valuer can provide professional guarantees assuring effective performance. The AIFM must also establish that the delegation safeguards set out in FUND 3.10.2R, 3.10.4R and the Level 2 Regulation have been duly met.

- 8.5** Many respondents to DP12/1 asked about the nature of the professional guarantees to be given.⁹⁵ We expect the final Level 2 Regulation will address these points.
- 8.6** The AIFM remains responsible for the proper valuation of AIF assets, the calculation of the NAV and its publication.⁹⁶ The external valuer will be liable to the AIFM for any losses suffered as a consequence of its negligence or intentional performance failure, notwithstanding that the contract between the AIF or the AIFM and the external valuer might seek to exclude this liability. The Treasury regulations will set out the obligations to be imposed on external valuers.

Calculation of the NAV

- 8.7** AIFMs must have appropriate and consistent procedures to calculate and disclose the NAV per unit or share to investors. An AIFM is likely to be required by the Level 2 Regulation to ensure that, for each AIF it manages, the NAV per unit or share is calculated on each issue, subscription, redemption or cancellation of units or shares, but in any event at least once a year.
- 8.8** The Directive does not prescribe in detail how the NAV should be calculated, but states that the calculation must be in accordance with national law and the instruments constituting the fund.⁹⁷ We do not propose to provide further guidance on this for AIFs in general, but we intend to retain our existing rules and guidance in relation to authorised funds.

Liquidity management

- 8.9** As we explained in paragraphs 5.14 to 5.26 of DP12/1, the Directive requires AIFMs to use appropriate liquidity management systems and procedures for the AIFs they manage. UK-authorised AIFMs will have to monitor, assess and stress-test the liquidity risk of their AIFs and ensure that the liquidity profile of the underlying investments is consistent with the AIF's obligations and redemption policy. These requirements are transposed in FUND 3.6.
- 8.10** The Level 2 Regulation will specify what these liquidity management systems and procedures should be, and the criteria according to which the investment strategy, liquidity profile and redemption policy of the relevant AIFs under management will be considered to be aligned. FUND 3.6 will contain a link to the relevant Articles and Recitals of the final Level 2 Regulation.
- 8.11** FUND 3.6.3R, which transposes the liquidity management requirements in Article 16(1), does not apply to unleveraged, closed-ended AIFs. Article 16(2) of the Directive, which requires AIFMs to ensure that, for each AIF they manage, the investment strategy, liquidity profile and redemption policy are consistent, is transposed by FUND 3.6.2R. We propose

⁹⁵ Question 26 of DP12/1.

⁹⁶ FUND 3.9.2R.

⁹⁷ FUND 3.9.4R.

to apply this rule for all AIFs, noting that unleveraged closed-ended AIFs may also have occasional redemptions.

- 8.12** ESMA's draft RTS on types of AIFM are expected to address the difference between a closed-ended AIF and an open-ended AIF. We therefore do not propose our own definition of a closed-ended AIF for FUND 3.6.
- 8.13** The requirements on AIFMs to disclose and report on liquidity management are explained in Chapter 6 (Transparency).

Exceptional measures

- 8.14** Where an AIFM considers the use of exceptional liquidity measures such as gates, side pockets, lock-ups, notice periods, redemption penalties or suspensions, this must be done in accordance with the AIF's liquidity policy and the principle of the fair treatment of all investors in the AIF.⁹⁸ We expect the Level 2 Regulation will require the AIFM to identify both the normal and exceptional circumstances in which these measures may be used.

Preparations for firms becoming AIFMs

- 8.15** In DP12/1, we asked AIFMs whether there were any particular challenges to them as a result of the liquidity requirements.⁹⁹ Some respondents noted that liquidity management was more difficult for assets where traded volumes data are not widely available. Others thought that closed-ended funds should be exempted from the liquidity management requirements. As explained in paragraph 8.11, we intend to exempt AIFMs managing unleveraged closed-ended funds from FUND 3.6.3R, but not from the other liquidity requirements because closed-ended AIFs may still carry out occasional redemptions. All of the liquidity requirements will apply to leveraged closed-ended AIFs as AIFMs will need to ensure that there are sufficient funds to repay debts as they fall due.
- 8.16** A firm becoming an AIFM will need to determine whether each of its AIFs is open-ended or closed-ended, review each AIF's constitutional documents to ensure that the investment strategy, liquidity and redemption policy are aligned, review any stress-testing and monitoring programmes against the new requirements, and ensure that it has appropriate disclosure and reporting processes in place.
- 8.17** UCITS management companies should already have liquidity risk management systems in place since they are not allowed to invest in securities which compromise their ability to redeem units in the fund.¹⁰⁰ However, AIFMD sets out more details on the liquidity management systems and procedures required and introduces specific liquidity stress testing and periodic disclosure requirements, which will be new for UCITS management companies becoming AIFMs.

⁹⁸ See also draft rule COBS 2.1.4R, which transposes Article 12(1) AIFMD.

⁹⁹ Question 28 of DP12/1.

¹⁰⁰ COLL 5.2.7AR (1)(b).

Leverage

- 8.18** The Directive introduces significant new regulation regarding the use of leverage by AIFMs and the calculation of the exposure of AIFs under management. It also requires the Commission to adopt subordinate measures specifying the methods by which AIFMs will calculate leverage used by their managed AIFs, including any financial and/or legal structures involving third parties controlled by the relevant AIF.¹⁰¹ However, the Directive excludes leverage at the level of a portfolio company for private equity and venture capital funds.¹⁰²

Transposition of the Directive's requirements on leverage

- 8.19** The leverage definition in the Directive¹⁰³ will be transposed into the Glossary of the Handbook. We expect the final Level 2 Regulation to specify more detailed requirements on how leverage is to be calculated. These will not be reproduced in the Handbook.
- 8.20** The Level 2 Regulation will require firms to use two methods to calculate the leverage of an AIF portfolio. The 'Gross' method is the sum of the absolute values of all positions. Along with other requirements, the Gross method requires derivative instruments to be converted into the equivalent position in their underlying assets. Whereas the Gross method may substantially increase the exposures of certain funds, such as those using foreign exchange or interest rate derivatives, by contrast the Commitment method allows certain prescribed netting and hedging relationships to be taken into account. The resulting calculations of the two methods should reveal an AIF's investment strategy and its exposure in ways that are relevant for investors and supervisors.

Using leverage data

- 8.21** AIFMs will use the data resulting from the two methods of leverage calculation in a number of situations contemplated by the Directive.
- 8.22** In relation to transparency requirements:
- to disclose to us the leverage amounts as part of AIF reporting¹⁰⁴; and
 - to disclose to investors the total amount of leverage and any changes to the maximum level of leverage employed by an AIF.¹⁰⁵
- 8.23** In relation to risk management requirements:
- to set a maximum level of leverage for each AIF that they manage¹⁰⁶;

¹⁰¹ Article 4(3)(a) and (b) AIFMD.

¹⁰² Recital 78 AIFMD.

¹⁰³ Article 4(1)(v) AIFMD.

¹⁰⁴ FUND 3.4.6R.

¹⁰⁵ FUND 3.2.6R.

¹⁰⁶ FUND 3.7.7.R (1).

- to demonstrate that the leverage limits they set are reasonable and that the AIF complies with those limits¹⁰⁷; and
- to determine whether an AIF is employing leverage on a substantial basis and, if so, disclose it to us.¹⁰⁸

Limits on use of leverage and other supervisory restrictions

- 8.24** The Directive requires an AIFM to demonstrate that the leverage limits it sets for each AIF it manages are reasonable and that it complies with those limits at all times. We have transposed these requirements on AIFMs in FUND 3.7.8R.
- 8.25** The Level 2 Regulation is expected to set out indicative criteria which national competent authorities should take into account in their assessment of systemic risk in the AIFM sector and to determine whether or not they should place limits or other supervisory restrictions on the use of leverage by AIFMs. We expect to take into account the following circumstances or criteria:
- where the exposure of an AIF or several AIFs could constitute a material source of market, liquidity or counterparty risk to a financial institution;
 - where the activities of an AIFM or its interaction with a group of AIFMs or other financial institutions contribute to a downward spiral in the prices of financial instruments which threatens the viability of such financial instruments;
 - the type or investment strategy of the AIF, the market conditions and any likely pro-cyclical effects that may result from the imposition by the competent authorities of limits to the use of leverage; and
 - the size of an AIF or AIFs, the concentration of risks in particular markets, any contagion risk, liquidity issues and the scale of asset/liability mismatch in a particular AIF investment strategy or irregular evolution of prices of assets.
- 8.26** Before becoming authorised AIFMs, firms will need to review their policies on using leverage and ensure these are reasonable and compliant with AIFMD requirements.
- 8.27** National competent authorities will be required to share data concerning leverage with other EU competent authorities, ESMA and the European Systemic Risk Board.¹⁰⁹

Investment in securitisation positions

- 8.28** The Directive includes a requirement for the Commission to adopt subordinate measures in respect of certain securitisation positions. Such requirements will need to be met by an

¹⁰⁷ FUND 3.7.8R.

¹⁰⁸ FUND 3.4.6R and 3.4.7R.

¹⁰⁹ Article 25(2) AIFMD.

originator, sponsor or original lender in relation to the securitisation positions in order for an AIFM to be able to invest therein. FUND 3.5 will in due course contain a link to the Level 2 Regulation containing the additional risk management requirements on investment in securitisation positions.

9

Depositories

- 9.1** This chapter describes our proposals for depositories of AIFs, including who can be a depository, what capital requirements should apply, how the regime for ‘private equity AIF’ depositories should work, the independence requirement for depositories, rules for carrying on depository functions for non-EEA AIFs, and the transitional provision relating to EEA credit institutions acting as AIF depositories.
- 9.2** In Chapter 7 of DP12/1 we set out some of the key implementation issues relating to depositories of AIFs, including who can be appointed to the role, their duties and the extent of their liability. Much of the detail relating to these issues will be determined by the Level 2 Regulation, but there are some areas of national discretion on which we are consulting.
- 9.3** FUND 3.11 transposes parts of Article 21 of the Directive, which prescribe the requirements that AIF depositories must follow. Other parts of Article 21, relating to the depository’s legal liability and the circumstances in which it can discharge that liability, will be transposed by the Treasury regulations and will not be included in the Handbook.
- 9.4** FUND 3.11 contains rules and guidance on:
- the duties of the AIFM concerning appointing a depository;
 - general duties of the AIFM and depository, and avoiding conflicts of interest;
 - eligibility to be a depository of an AIF;
 - the functions of the depository;
 - delegating the safekeeping function; and
 - performing depository functions for a non-EEA AIF.
- 9.5** We are currently considering whether the rules in the Client Assets sourcebook (CASS) that apply to depositories are fully aligned with the Level 1 and Level 2 provisions of AIFMD. We will address any matters that require a change to CASS, or a clarification, in CP2.

Contents of the Regulation

- 9.6 The Level 2 Regulation will add substantial detail to most of the depositary requirements. It is expected to cover matters such as:
- what should be included in the depositary agreement;
 - how the depositary should perform its duties of cash monitoring, safekeeping of assets and oversight;
 - matters relating to custody of financial assets, including segregation of assets, reporting and the status of assets given as collateral; and
 - the depositary's liability, including when assets should be considered to be lost and which external events are outside the depositary's liability.

Obligations of the AIFM and the depositary

- 9.7 The AIFM of a UK AIF or an EEA AIF has certain Directive obligations regarding the depositary, irrespective of whether or not the AIF's constitutional instrument makes the AIFM responsible for selecting and appointing the depositary. The AIFM must ensure that: a single depositary meeting the eligibility criteria set out in the Directive is appointed for each such AIF; the appointment is supported by a written contract; and the assets of that AIF are entrusted to the depositary for safekeeping (FUND 3.11.3R, 3.11.9R, 3.11.15R and 3.11.16R). The AIFM must ensure that the depositary is eligible to act for that particular AIF, which in the case of a UK AIF means ensuring the depositary has the relevant FSA authorisation.
- 9.8 The AIFM and the depositary each have a duty to perform their respective roles in the interests of the AIF and its investors by acting honestly, fairly and independently (FUND 3.11.4R). We say more in paragraph 9.35 to 9.40 about the concept of acting independently. The AIFM also has a duty to avoid conflicts of interest between itself, the depositary and the AIF, especially where a firm is acting as both depositary and prime broker to the AIF (FUND 3.11.6R).
- 9.9 The depositary also has specific obligations to ensure proper management of potential conflicts of interest (FUND 3.11.8R). The duties of cash monitoring, safekeeping assets and oversight are set out in FUND 3.11.17R, 3.11.18R, 3.11.20R and 3.11.22R, although the Level 2 Regulation will provide most of the detail about these duties. FUND 3.11.23R to 3.11.28G set out the limitations on the depositary's ability to delegate its functions.

Who can be a depositary?

- 9.10 The Commission's decision to implement most of the Level 2 measures through a directly-applicable Regulation has meant that we now have no national discretion in

many areas where questions about the costs and benefits of policy options might otherwise have determined our course of action. Many respondents to DP12/1 voiced concerns about the costs of appointing a depositary where none currently exists¹¹⁰, but we cannot alleviate costs that are a consequence of the Directive's investor protection measures.

- 9.11** We are, however, mindful of these concerns, especially in terms of allowing a competitive market to emerge for the provision of depositary services in the UK. Currently only a small number of firms carry on the regulated activity of acting as trustee/depositary of authorised funds.¹¹¹ These are specialised roles, and while there is no reason in principle why the firms performing them should not extend their activities to a wider range of AIFs, there is equally no reason why other firms should not enter the market to meet the needs of AIFs that have not previously used a depositary.
- 9.12** The Directive allows any UK firm authorised as a credit institution, and certain types of MiFID firm, to act as depositary for any type of AIF. It also allows other firms that were permitted under national law (as of July 2011) to be depositaries of UCITS, to act as AIF depositaries as well. We interpret this to mean that only firms that were actually authorised as depositaries at the relevant date are eligible under this category, so no new firms can be added to it.
- 9.13** The Directive does not specify any process for the authorisation of depositaries or apply additional capital requirements in relation to them. However, since acting as a depositary of an AIF will be a specified activity under the Regulated Activities Order as explained in Chapter 4, any firm wishing to carry it out will need to apply to the FCA for the relevant Part IV permission unless there is an exemption in place under FSMA.
- 9.14** In DP12/1 we noted that a firm currently acting as trustee or depositary of an authorised fund requires minimum fixed capital of £4m.¹¹² We asked whether this amount should be increased, and whether a different basis of calculation should be used.¹¹³ There were mixed views – some respondents agreed that an increase was justified, if only to reflect inflation since the figure was originally set, but others argued that an own-funds requirement can never be sufficient to offset the potential liability where assets are lost, so other measures would be more appropriate.
- 9.15** We have decided not to make any changes to this rule for the time being, in light of the UCITS V proposals that aim to restrict the types of entity that can act as a depositary and to impose a higher standard of liability on them. We think it would be better to wait for the outcome of negotiations on these proposals before reviewing the capital requirements for depositaries of authorised funds, whether they are UCITS schemes or AIFs.

110 Question 38 of DP12/1.

111 Performing a similar function for an unregulated CIS is not a regulated activity in itself, although it may involve safeguarding and administering investments, which is a regulated activity.

112 This refers to a firm that is not also a credit institution or a MiFID investment firm, as these latter types of firm would be subject to the capital requirements in GENPRU and BIPRU.

113 Question 39 of DP12/1.

- 9.16** This means that existing depositaries of NURS and QIS would be subject to a higher capital requirement than a MiFID firm (i.e. a 'BIPRU 730K firm') that chose to become a depositary under AIFMD. We propose a new rule (FUND 3.11.13R)¹¹⁴ requiring any MiFID firm acting as a depositary for an authorised AIF to hold £4m fixed capital, thus making it subject to the same capital requirements as other firms performing the same activity. New depositaries that do not wish to act for authorised AIFs will not be subject to any national requirements on capital over and above the EU regimes specific to credit institutions or MiFID firms, as set out in GENPRU and BIPRU.

Q8: Are the proposed capital requirements for firms that act as depositaries for authorised AIFs fair and appropriate?

The 'private equity (PE) AIF depositary' model

- 9.17** We explained in DP12/1 that for certain types of AIF¹¹⁵ the role of depositary may also be performed by an entity which 'is subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct'. Recital 34 adds that Member States may allow a notary, lawyer, registrar or other entity to be appointed, in accordance with current practice for certain types of closed-ended funds.
- 9.18** We asked whether firms such as lawyers, accountants or fund administrators intend to offer this type of depositary service, and what prudential regime or other regulatory requirements should apply.¹¹⁶ There were no responses to this question from professional firms such as accountants or lawyers, although a few firms providing specialist administrative and accounting services to private equity and real estate funds indicated their interest and responded to our questions, as did several others. A common theme in the responses was a concern that many smaller fund managers may struggle to find a suitable depositary for their funds unless more firms are able to offer the service at a competitive price. That, in turn, would depend on whether the capital requirements for such firms were set lower than for depositaries of authorised funds.
- 9.19** The UK Authorities consider there is sufficient support for this option to justify implementing it, as explained in the Treasury consultation document. We must determine exactly which categories of firm can benefit from this derogation and what requirements should apply to them. For convenience we refer in this chapter to 'PE AIF depositaries', since private equity funds are typical of the type of fund the regime is designed for (although some PE funds might not fit the specification, whereas some other types of fund will).

¹¹⁴ This rule is in FUND because it derives from the AIFMD. The MiFID firm will also be subject to the requirements in GENPRU and BIPRU, which derive from the application of the CRD.

¹¹⁵ AIFs which '... have no redemption rights exercisable [for] five years from the date of the initial investments and which, in accordance with their investment policy, generally do not invest in assets that must be held in custody...or generally invest in issuers or non-listed companies to potentially acquire control over such companies...'. Article 21.3(c) AIFMD.

¹¹⁶ Question 40 of DP12/1.

- 9.20** The description of which entities may perform this role is fairly wide-ranging, so we need to decide whether it applies to some or all professional firms (as defined in our Handbook), and whether entities other than professional firms can also meet the definition.
- 9.21** Professional firms can be authorised by the FSA or, if they are regulated by a designated professional body (DPB), they may undertake certain regulated activities on an exempt basis. Such activities must be ancillary to the firm's main business and undertaken purely as part of that business. The rules of the relevant DPB apply to such business and most Handbook provisions are accordingly disapplied.¹¹⁷
- 9.22** We have considered whether the DPB regime is appropriate for PE AIF depositaries. Professional firms do not, as far as we know, currently undertake all the functions that depositaries will be required to perform, so we cannot expect either professional firms or their DPBs to be familiar with the Directive's requirements. Nor can these functions be regarded as ancillary to the mainstream business of a professional firm, because of the expected level of detail in the Level 2 Regulation. Acting as a PE AIF depositary is not, in our view, the kind of exempt activity the DPB regime is intended for. Given our own responsibilities for supervising the proper implementation of the Directive, we believe it is necessary to ensure that all such firms are authorised.
- 9.23** Restricting the role of a PE AIF depositary to professional firms authorised by the FSA would, in theory, mean around 300 firms could potentially provide such services. Many of these are sole traders or small firms, which might be unlikely to wish to carry on such business. However, we believe the Directive – in referring to firms 'subject to legal or regulatory provisions' – allows a firm other than a professional firm to be authorised to perform this activity (FUND 3.11.10R).
- 9.24** Given the specialised nature of the activity, we do not expect many other authorised firms to see it as commercially viable to put in place the expertise and the organisational capability to perform it. Also, some firms would be subject to inherent conflicts of interest that would make it impossible or unsuitable for them to operate as depositaries; for example, AIFMs and UCITS management companies. But, subject to those exceptions, it should be possible in principle for a firm to be given the Part IV permission of acting as an AIF depositary with a limitation to PE AIFs, if it can demonstrate a sufficient standard of skill, care and diligence.
- 9.25** Such skill might be demonstrated in various ways; for example, on the basis that members of the governing body of the firm individually hold a relevant professional qualification, or that the firm has some form of independent accreditation relating to the services it provides for a particular category of fund.
- 9.26** We intend to construe the Directive requirement, that such a firm must carry out depositary functions 'as part of its professional or business activities', to allow an authorised professional firm to offer the service to a client on a stand-alone basis. In other words, the

¹¹⁷ The Handbook also defines the concept of a 'non-mainstream regulated activity', which allows an authorised professional firm to carry on exempt activities under an equivalent regime to an exempt professional firm.

firm would not have to provide it as a part of a package of professional services if the client did not wish to use those other services.

- 9.27** There is also a question about exactly which activities the depositary will perform. The Directive concession applies to funds that ‘generally do not invest in assets that must be held in custody’. This implies that it is acceptable for such AIFs to hold assets in custody in some circumstances. An AIF depositary does not require the separate permission of safeguarding and administering assets in relation to the AIFs it acts for, so a PE AIF depositary will be able to hold assets in custody unless we specify otherwise. It is likely, however, that for some AIFs, there will be no custody obligation and the depositary will need only to verify the ownership of the AIF’s assets.

Q9: Do you agree with our approach permitting authorised professional firms and other suitably qualified firms to be authorised to carry on the activity of acting as a PE AIF depositary?

Q10: What standards should we apply to determine that a firm, which is not a professional firm, is fit and proper to perform this function?

Q11: Do you agree that it may be necessary or desirable for PE AIF depositaries to be able to hold financial assets in custody?

Capital requirements for firms acting as PE AIF depositaries

- 9.28** AIFMD does not place any specific prudential requirements on a PE AIF depositary, other than it being able to provide sufficient professional and financial guarantees. In this context, we interpret ‘financial guarantees’ as including a capital requirement of the kind most FSA-authorised firms are subject to.
- 9.29** We have received consistent feedback from both fund managers and others that a substantial capital requirement would deter firms from providing AIF depositary services. This is especially a concern for the PE AIF market where there are very few existing service providers that might become depositaries. If we required PE AIF depositaries to hold the same capital as a MiFID firm acting as a depositary to AIFs other than authorised funds, i.e. minimum capital of €730,000, it is likely this would act as a barrier to market entry for small firms.
- 9.30** We recognise the importance of promoting competition for financial services, while at the same time we need assurance that firms are fit and proper to carry out the depositary

functions, especially as an AIF depositary has a function of oversight of the AIFM. It is important for an authorised person who is overseeing the activities of another authorised person to itself be subject to a robust regulatory regime.

- 9.31** In looking for an appropriate level at which to set the capital requirement, we have noted a MiFID firm that complies with BIPRU 1.1.19R (a ‘BIPRU 125K firm’) has permission to hold client money and to carry on safeguarding and administering of assets¹¹⁸, and is subject to a capital requirement of €125,000. MiFID firms subject to a lower capital requirement cannot hold client money or securities. We believe that a BIPRU 125K firm offers an appropriate benchmark for an AIF depositary, in terms of the risks to which it is subject through having responsibility for client assets (an AIF depositary will need at the least to be able to hold cash on behalf of the fund and its investors).
- 9.32** Consequently, we propose that a firm acting as a PE AIF depositary should, as a minimum, hold own funds of at least €125,000. This would apply where the depositary’s safekeeping duty is limited to verifying the ownership of the AIF’s assets. If the firm intends to undertake higher-risk activities, such as providing custody of financial assets (to the extent that a PE AIF depositary would be allowed to do so) it may be appropriate for us to set a higher figure. We might do this by setting a higher own funds requirement, or by applying an expenditure-based requirement.
- 9.33** We believe that this approach to setting the capital requirement would be likely to make the provision of the service commercially competitive in terms of firms’ ability to enter the market. At the same time, it is high enough to provide a sufficient capital buffer for investor protection purposes in the event of the firm being unable to meet its obligations.
- 9.34** Although a PE AIF depositary would hold the same Part IV permission as other AIF depositaries, our draft rules FUND 3.11.10R and 3.11.11R will specify that where its activities are restricted to the specified types of AIF, it will be subject to these specialised capital requirements in IPRU(INV).

Q12: Do you agree with the proposed approach to setting capital requirements for firms acting as PE AIF depositaries? If not, please give reasons.

Q13: Should such depositaries be subject to different requirements, depending on whether or not they may hold financial instruments in custody? If so, what type of requirement would be most appropriate for these higher-risk firms: more own funds, an expenditure-based requirement, or some other method of calculation (please specify)?

¹¹⁸ Current EU proposals to modify MiFID would make safeguarding of assets a core activity rather than an ancillary activity as now, which could result in higher capital requirements for firms performing it.

Independence of depositaries

- 9.35** Article 21(4) states that an AIFM must not act as depositary and 21(10) that the AIFM and the depositary must act independently in their respective roles, in the interests of the AIF and its investors.
- 9.36** We asked in DP12/1 whether the depositary of an AIF should be permitted to be part of the same group as its AIFM.¹¹⁹ A majority of respondents agreed this should be allowed and some gave instances of requirements that would enable the entities to act independently, such as having information barriers in place and ensuring the economic interests of each entity's personnel are sufficiently separated. Some, however, thought it was an incorrect interpretation of the Directive and a few were concerned about conflicts of interest where the depositary is holding title for assets of the AIF.
- 9.37** For depositaries of UK-authorised funds, we currently apply a stricter standard not derived from any EU legislation, which requires the depositary to be independent from the group of which the fund manager is part. The DP responses did not indicate any significant desire to modify this standard of independence for NURS and QIS depositaries, and we confirm that we do not intend to do so.
- 9.38** We agree, however, that applying a strict standard of independence to all AIF depositaries is likely to be disproportionate in relation to many professional funds. We believe the 'acting independently' test can still be satisfied when the AIFM and depositary of the same AIF are separate but connected entities in the same group, provided there is proper management and disclosure of potential conflicts of interest. Allowing more flexibility for the depositary of unauthorised funds should promote competition and consequently reduce cost.
- 9.39** Therefore, we propose that an AIF other than an authorised fund, or its AIFM on its behalf, should be able to appoint an affiliate of the AIFM as depositary if it meets the Directive requirements and there is proper management of any conflicts of interest (FUND 3.11.5G). To reduce the risk of such conflicts arising, FUND 3.11.6R(1) specifies that an AIFM cannot perform any function of a depositary as its delegate.
- 9.40** One area in which management of conflicts might be difficult relates to custody arrangements. It might not be in the best interests of investors to allow title to the AIF's assets to be held by a depositary in the same group as the AIFM, instead of the AIF itself or an independent third party; although there might of course be cost considerations that make an intra-group option desirable. We welcome the views of respondents to this paper on whether we should mandate requirements or give guidance in this area.

Q14: Do you agree with our approach permitting AIF depositaries to be in the same group as the AIFM so long as Directive requirements are met?

¹¹⁹ Question 45 in DP12/1 was asked in the specific context of non-EEA AIFs being marketed in the UK, but many respondents treated it in a more general way and we acknowledge that these considerations apply to a broad range of UK AIFs.

Q15: What additional safeguards, if any, should there be to ensure effective management of conflicts of interest, especially in relation to custody of AIF assets?

Depositories for non-EEA AIFs

- 9.41** We explained in DP12/1 that Article 36 imposes a limited depositary requirement on a UK AIFM managing a non-EEA AIF that is to be marketed in the UK under national private placement.¹²⁰ The AIFM must ensure that one or more firms carry out the essential depositary functions of cash monitoring, safekeeping of assets and oversight, but the rest of the depositary provisions (e.g. on independence, segregation and liability) do not apply.
- 9.42** We asked in DP12/1 what the appropriate regulatory treatment would be for a UK firm that wished to offer these depositary services.¹²¹ All respondents agreed that these firms should be subject to some form of regulation, although views differed about whether it should be the full AIF depositary regime or something equivalent to current regulation of these functions. There were no suggestions about particular industry codes or principles of best practice that might take the place of regulation.
- 9.43** One approach, which several respondents proposed, would be to require all such firms to hold the Part IV permission of ‘acting as an AIF depositary’. This approach might be burdensome for a firm that did not intend to provide all the prescribed functions, especially since stand-alone functions, such as cash monitoring, are not regulated activities when performed in any other context. However, we have had no clear indication so far that any firms would be looking to provide stand-alone services of this kind, as opposed to making them an add-on to a mainstream depositary service for UK AIFs.
- 9.44** On that basis, we propose to require all UK firms offering this type of depositary service to be authorised as a full AIF depositary (FUND 3.11.30R) although only subject to the rules on cash monitoring, safekeeping of assets and oversight. It would be open to those firms to limit their activities to a particular type of AIF, such as ‘PE AIFs’, to benefit from the specialised capital requirements we propose. We would be particularly keen to receive responses from firms that may be interested in providing depositary services to non-EEA AIFs, about whether this regime would be proportionate.

Q16: Do you agree with our approach requiring UK firms providing depositary services under Article 36 to hold a Part IV permission to be an AIF depositary?

¹²⁰ Paragraphs 7.19 to 7.21 of DP12/1; Article 36(1)(a) AIFMD.

¹²¹ Question 46 of DP12/1.

Transitional arrangements for appointing non-UK depositaries

- 9.45** The Directive allows flexibility for a credit institution that is authorised and has its registered office in the EU to act as depositary for AIFs established in any EEA State, for a period of four years until July 2017. We propose to implement this so that UK AIFs (other than authorised funds) may appoint an EEA (non-UK) credit institution in this role during the transitional period. We believe that this may be helpful to AIFMs of UK AIFs, as we do not yet know how many UK firms will be ready to act as AIF depositaries in the early days after implementation.
- 9.46** We propose to exclude authorised funds (NURS and QIS) from this arrangement because they are subject to a UK-specific regime that will be unfamiliar to non-UK depositaries. Also, they already have a depositary and (unless the existing depositary withdraws from the market) the AIFM should not need to appoint a new one to become AIFMD-compliant. Even if a new appointment were necessary, we do not think a compelling case can be made that switching to a non-UK depositary for a limited period and then switching back again to a UK firm, when the transitional provision expires, would be in the best interests of investors as long as there are alternative service providers in the UK.

Q17: Do you agree that EEA credit institutions should be allowed to act as depositary to UK AIFs? If you expect to be an AIFM of UK AIFs from 2013, would you consider using such a firm as depositary?

Q18: Should authorised funds be excluded from this arrangement?

10

Marketing

- 10.1** The Directive deals specifically with the marketing of AIFs to professional investors in the UK and other Member States. The UK transposition of these requirements will primarily be by Treasury regulations, and we expect the Treasury to consult on these new requirements. However, we take this opportunity to discuss a few related points here. We also intend to consult on any revised retail marketing requirements for AIFs in CP2.

Definition of 'marketing'

- 10.2** DP12/1 posed several questions about marketing AIFs.¹²² Respondents generally argued that certain communications and practices such as reverse solicitation, secondary transactions or communications about NAVs should not be considered marketing.
- 10.3** The Directive definition of 'marketing' is 'direct or indirect offering or placement at the initiative of the AIFM, or on behalf of the AIFM, of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union'.¹²³ We intend to transpose this definition into the Glossary of our Handbook.
- 10.4** Despite the overlap between the concepts of marketing under the AIFMD and a promotion under the FSMA financial promotion orders¹²⁴, marketing under the AIFMD contains distinctive features outside the FSMA definition. In particular, the prohibitions on financial promotions¹²⁵ do not include the AIFMD concept on 'the placing of units or shares of an AIF with investors', while some activities of placement agents to promote new AIFs may not be included in the AIFMD concept.

¹²² Questions 50-52 of DP12/1.

¹²³ Article 4(1)(x) AIFMD.

¹²⁴ Financial Promotions Order 2005, Promotions of Collective Investment Schemes Order 2001 (S.I. 2001/1060).

¹²⁵ Sections 21 & 238 of FSMA.

Marketing notifications and passporting

- 10.5** Articles 31 and 32 of the Directive relate to the marketing of AIFs managed by authorised AIFMs both domestically and in other Member States. Annexes III and IV of the Directive set out the documentation requirements needed to notify the AIFM's competent authority of the planned marketing of an AIF in the AIFM's home Member State or in other Member States.

National private placement

- 10.6** The Directive also gives Member States discretion to retain or put in place national marketing regimes for offerings to professional investors ('private placement regime'). Respondents to DP12/1 generally supported the current private placement regime in the UK, and suggested that only minimal changes be made to the regime as a result of AIFMD, such as a public register of privately placed funds.¹²⁶
- 10.7** Where a UK or EEA AIFM wishes to market a non-EEA AIF in the EEA, the Directive allows Member States to maintain a private placement regime subject to certain conditions such as that:¹²⁷
- the AIFM must comply with the AIFMD except for certain depositary requirements;
 - appropriate cooperation arrangements are in place between the competent authorities of the AIFM's home Member State and the supervisory authorities of the third country where the non-EEA AIF is established; and
 - the third country where the non-EEA AIF is established is not listed as a non-cooperative country or territory by the Financial Action Task Force (FATF).
- 10.8** Similarly for non-EEA AIFMs who wish to market an AIF in the EU, the Directive allows Member States to maintain a private placement regime subject to certain conditions such as that¹²⁸:
- the AIFM must only comply with the transparency requirements and, where applicable, also the private equity notification requirements;
 - appropriate cooperation arrangements are in place, as applicable, between the competent authorities of the Member States where the AIFs are marketed, the competent authorities of the EEA AIFs concerned, and the supervisory authorities of the third EEA country where the non-EEA AIF or AIFM is established; and
 - the third country where the non-EEA AIF or AIFM is established is not listed as a non-cooperative country or territory by the FATE.

¹²⁶ Question 53 of DP12/1.

¹²⁷ Article 36 (1) AIFMD.

¹²⁸ Article 42 (1) AIFMD

Annex 1

Cost benefit analysis (CBA)

1. This Annex provides a CBA of the policy proposals outlined in this CP. It is our expectation that the changes proposed in this CP will be made by the board of the FCA, rather than by the FSA. As a result, the relevant CBA requirements are those set out in section 138I of the Bill rather than those in section 155 of the original version of FSMA.¹
2. We consider that this CBA meets the draft revised FSMA CBA requirements. Section 138I of the revised version of FSMA is currently before Parliament and we will review the CBA if those requirements change.
3. We only have a legal obligation to publish a CBA for proposed changes to rules contained in the Handbook. This means that for AIFMD we only have to assess the impacts of the rules transposing the Directive itself (Level 1). The Level 2 Regulation, on the other hand, will be directly applicable in the UK and other Member States. To the extent that it does not require making any changes to the Handbook, we do not have a legal obligation to assess these impacts in the CBA.
4. In practice, however, it is difficult or sometimes even impossible to separate the cost impacts that will arise from the Level 1 Directive and the Level 2 Regulation. The Directive often outlines the high-level principles, but the costs largely arise from the more specific Level 2 requirements. Because of this we have decided to publish a high-level CBA that covers both the Directive and the forthcoming Level 2 Regulation, where possible. By doing this we, however, do not intend to set a precedent for future CBAs on implementation of EU Directives.

¹ The FCA will be required to carry out and publish a CBA when proposing draft rules and when making rules which are significantly different from the draft consulted on. In particular, they will be required to publish 'an analysis of the costs together with an analysis of the benefits...and an estimate of those costs and of those benefits'. However, if, in a regulator's opinion, the costs or benefits cannot reasonably be estimated or it is not reasonably practicable to produce an estimate, an estimate need not be provided; but in this case, the regulator must explain why it is of that opinion. Finally, no CBA is required if a regulator considers that there will be no increase in costs or there will be a cost increase of minimal significance.

5. This CBA is structured as follows:
- our approach to the CBA;
 - overview of the population of firms affected;
 - costs;
 - market impacts; and
 - benefits.

Our approach to the CBA

The relevant baseline

6. The CBA has to make an appropriate comparison between the overall position if the proposed regulatory changes are applied and the overall position if they are not (i.e. the baseline).
7. In the case of AIFMD, we consider the appropriate baseline to be the *status quo*: the current regulation that the different types of firms are subject to (or the absence of it) and current business practice. Where there is discretion in AIFMD for the FCA to apply different rules (e.g. reporting, capital, depositary requirements), we also consider the impact of the additional requirements imposed by the FCA.
8. This CBA does not assess the impact on small firms falling below the thresholds in Article 3(2) of the Directive, as these impacts will depend on the forthcoming Treasury decisions following consultation. We also do not assess the impact of the transitional provisions, though these are likely to reduce firms' one-off compliance costs.

Data sources and level of analysis

9. The CBA is based on internal FSA analysis, the results of a firm survey sent to potential AIFMs, discussions with stakeholders and input from our policy and supervisory experts. We are grateful to all who contributed to the CBA. We also draw on publicly available analysis, mainly the following reports:
- Charles River Associates (2009) 'Impact of the proposed AIFMD Directive across Europe'.² The CRA report was commissioned by the FSA.
 - Deloitte (2012) 'Responding to the new reality: Alternative Investment Fund Managers Directive Survey'.³

² The CRA report can be accessed here: www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf

³ The Deloitte report can be accessed here: www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-aifmd-survey-responding-new-reality.pdf

- Ernst & Young (2012) 'AIFMD: get ready for European depositary reform'.⁴
 - The European commission's impact assessment from 2009.⁵
10. The FSA's preliminary firm survey was sent to a sample of potential AIFMs in April 2012. It outlined at a high level the requirements in the Level 1 Directive and the draft Level 2 Regulation, and asked firms to estimate costs and assess business model impacts. From the 36 firms that responded, 22 firms expected to have UK AIFMs within their group structures and to be above the AIFMD Article 3(2) thresholds. These AIFMs managed around £179.5bn worth of assets in AIFs. Other respondents either had not completely filled out the survey, expected to be below the Article 3(2) thresholds, or did not expect to have UK AIFMs.
 11. Almost all respondents found it difficult to provide meaningful and detailed cost estimates, as, at the time we were surveying firms, there was still uncertainty about the content and impact of the Level 2 requirements.
 12. Unfortunately, we received too few responses for these to be representative of the whole highly heterogeneous, population of funds to be managed by future AIFMs. We therefore have not quantitatively assessed the impact on the specific types of AIFMs.

Overview of the population of firms affected

13. AIFMD will directly affect managers of different types of AIFs, including UCIS covering hedge funds, private equity, venture capital and real estate funds; investment trusts; NURS and other types of investment funds.
14. However, it is not yet fully determined which types of AIFMs will be in scope of AIFMD. ESMA is currently developing technical standards on this matter, and as the Level 2 Regulation has not yet been finalised, assessing the AIFMD perimeter is beyond the scope of this CP and CBA.
15. The AIFMD will also affect other types of firms that provide services to AIFMs, predominantly:
 - depositaries;
 - prime brokers;
 - valuation agents; and
 - other administrators and service providers.

4 The Ernst & Young report can be accessed here: [www.ey.com/Publication/vwLUAssets/AIFMD_-_prepare_for_European_depository_reform/\\$FILE/AIFMD_20March2012.pdf](http://www.ey.com/Publication/vwLUAssets/AIFMD_-_prepare_for_European_depository_reform/$FILE/AIFMD_20March2012.pdf)

5 European Commission's impact assessment (http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_impact_assessment.pdf) and the CRA report (www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf)

Costs

Direct costs to the FSA and the FCA

16. We estimate the one-off costs of implementing the AIFMD to be around £5m. These cover staff costs and costs of anticipated systems developments following the high-level gap analysis on the back of the initial interpretation of the Directive.
17. Additional supervisory staff may be needed on an ongoing basis due to the increase in the number of regulated firms. However, most potential AIFMs are already authorised by the FSA, so we do not expect a significant number of new managers, either start-ups or new entities consolidating previous businesses. In particular, investment managers of NURS, QIS, UCIS and externally managed investment trusts are already authorised and supervised by the FSA.

Compliance costs to AIFMs

18. Incremental compliance costs arising from the changes to parts of the Handbook are dealt with on a topic-by-topic basis in paragraphs 20 to 65.
19. Table 1 gives an overview of the ranges of cost estimates provided by firms.⁶ The fact that cost ranges are very wide reflects that the impact will vary greatly across the industry. In this and other cost summary tables, '£0' covers cases where firms indicated that they will not incur costs or where firms thought these costs are likely to be of minimal significance. Also, not all costs were quantified in the CBA survey, and the effects of the following requirements are discussed only qualitatively:
 - securitisation requirements;
 - liquid asset requirements; and
 - requirements for depositaries.

⁶ These estimates cover both staff costs and non-staff costs, such as costs of updating electronic systems. To quantify staff costs we assumed average annual salary of £50,000 plus 30% overheads.

Table 1: Summary of costs reported by AIFMs

Requirements		Incremental costs	
		One-off	Ongoing (annual)
Authorisation or variation in permissions	Authorisation	£11,000 – £127,000	NA
	Variation of permissions	£0 – £273,000	NA
Operating requirements		£0 – £480,000	£0 – £1,158,000
Delegation		£0 – £52,000	£0 – £243,000
Valuation		£0 – £26,000	£0 – £156,000
Liquidity management		£0 – £167,000	£0 – £185,000
Leverage		£0 – £186,000	£0 – £195,000
Transparency		£0 – £134,000	£0 – £156,000
Remuneration		£0 – £447,000	£0 – £185,000
Capital requirements		See Table 5	See Table 5

Authorisation or variation of permissions

20. AIFMs managing unleveraged closed-ended funds, for example, certain private equity, real estate or investment trust managers, with AUMs over £500m in AIFs and firms managing leveraged funds with assets above £100m in AIFs will need to be authorised by the FCA. For AIFMs that are currently already authorised by the FSA, this will amount to varying their permissions. The ranges of costs arising from authorisation requirements are provided in Table 2.

Table 2: Costs to firms from authorisation requirements

Requirement	One-off costs (per AIFM)	Estimated number of AIFMs in the first year	Estimated total costs (£m)
Authorisation (including new permissions)	£11,000 – £127,000	20 – 40	£0.22 – £5.08
Variation of permissions	£0 – £270,000	450 – 1150	£0 – £314

Operating requirements

21. The Directive and its implementing measures include certain organisational requirements. Most firms will not incur costs from these requirements or will only incur costs of minimal significance, as they already comply. This is either due to existing FSA requirements for the currently authorised firms or because the proposed requirements reflect current business practice. Regardless, one respondent noted that AIFMD is likely to expand the role of the compliance function, and this may also be the case in other areas. The cost estimates provided by the respondents to our firm survey are summarised in Table 3.
22. Firms also noted that costs will depend on proportionality provisions, as for some firms it would be disproportionate to the size and complexity of business to have separate functions. One firm was concerned that if the risk management rules are not applied in a proportionate way these could add up to £500,000 in costs annually. The respondents to the Deloitte survey indicated that smaller firms were much more concerned about meeting the new requirements than the larger firms.⁷

⁷ See www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-aifmd-survey-responding-new-reality.pdf

Table 3: Incremental costs to firms from operational requirements

Requirement	Incremental costs	
	One-off	Ongoing (annual)
Compliance function	£0 – £29,000	£0 – £400,000
Internal audit function	£0 – £26,000	£0 – £125,000
Suitable electronic systems for recording of transactions and subscriptions	£0 – £29,000	£0 – £103,000
Accounting policies and procedures	£0 – £29,000	£0 – £135,000
Due diligence	£0 – £22,000	£0 – £70,000
Appointment of counterparties and prime brokers	£0 – £153,000	£0 – £55,000
Fair treatment of investors	£0 – £22,000	£0 – £35,000
Risk management	£0 – £159,000	£0 – £200,000
Conflicts of interest	£0 – £11,000	£0 – £35,000
Total	£0 – £480,000	£0 – £1,158,000

Delegation requirements

23. The Directive will impose standards for delegates and sub-delegates, as well as requiring reviews and monitoring by AIFMs.⁸ AIFMs will have to seek prior approval from the FCA if they intend to delegate functions to third parties to carry out on their behalf. The AIFM will also have to review the services provided by each delegate on an ongoing basis.
24. Evidence from the FSA firm survey suggests that AIFMs are likely to incur incremental compliance costs (Table 4). Costs and impacts, however, will depend on what functions will be affected by the requirements in the forthcoming Level 2 Regulation.
25. Respondents to the Deloitte survey listed delegation as one of the most pressing concerns from a cost perspective. If the Level 2 Regulation sets a limit on the tasks that the AIFM can delegate that is more stringent than the current firm practice, firms may need to change business models. As Deloitte also notes, some internally managed funds may need to ‘insource’ functions that are currently delegated.

⁸ Article 20 AIFMD.

Table 4: Incremental costs to firms from delegation requirements

Requirement	Incremental costs	
	One-off	Ongoing (annual)
Reviewing services provided by each delegate	£0 – £26,000	£0 – £103,000
Reporting to FCA	£0 – £26,000	£0 – £140,000
Total	£0 – £52,000	£0 – £243,000

Prudential requirements

26. We have analysed most of the AIFMD requirements using available regulatory data that firms have reported to us.⁹ For the analysis of AIFMD capital requirements, we have used data from four prudential categories of firms subject to the following rules:
- IPRU (INV) Chapter 5 within the scope of 5.2.3R(2);
 - other IPRU (INV) Chapter 5;
 - UPRU; and
 - GENPRU-BIPRU.
27. Additionally, for internally-managed investment trusts, we have used data from their annual reports.
28. We have only analysed data for firms that are above the thresholds set out in Article 3(2) of the Directive.
29. We do not expect there will be any costs incurred from the renaming of firms in our Handbook to ‘CPM firms’ or ‘CPM Investment Firms’.
30. One of the key assumptions that we have made relates to assets under management in AIF portfolios (‘AIFMD capital AUM’). This is a major constituent of the capital requirement calculations in Article 9.¹⁰ AIFMD capital AUM data is not currently collected by the FSA, but we do receive some information about total assets under management, including borrowed assets, from those firms with the managing investments permission (FSA038).
31. For some firms, the actual AIFMD capital AUM will be higher than disclosed to us, because of leverage, or lower for those firms having assets in managed accounts and UCITS, i.e. non-AIF portfolios. For the purpose of our analysis, we have therefore assumed that the AUM data gathered from firms will be sufficiently similar to AIFMD capital AUM, except for UCITS managers, where this is unlikely to be the case as their assets will primarily be non-AIF portfolios.

⁹ Such reporting is based on existing prudential categories of firms such as IPRU (INV) Chapter 5 (fund managers and venture capital firms) who are required to submit FSA035 or GENPRU-BIPRU (MiFID-scope managers) who are required to submit FSA003.

¹⁰ The Level 2 Regulation is expected to define ‘the value of the portfolios of AIFs managed’.

32. We propose not to offer firms the option to use the guarantee allowed by Article 9(6) of the Directive because we do not expect many firms to use the guarantee. This is because of the likely small amount of the capital requirement that it can cover (see Table 5) and the costs arising from entering into an appropriate guarantee arrangement. If firms respond that they would want to use one, we will revisit the proposal and update the CBA.
33. In addition to the costs discussed in the sub-sections below, some respondents to the survey noted that they will incur one-off costs in form of professional or legal fees of around £10,000-£20,000.

Fund managers including those also authorised for MiFID business

34. We also analysed the impact on capital requirements for fund managers, which include, firstly, fund managers subject to the prudential rules in IPRU(INV) Chapter 5 and, secondly, those that undertake MiFID business and are BIPRU limited licence firms. The current capital requirements are quite high, as they were originally designed for banks and these firms generally report significant own funds and liquid capital which are more than sufficient to meet the AIFMD requirements.
35. The most relevant new requirement will be for PII or additional own funds to meet the professional negligence requirement of Article 9(7), which could be significant if the AIFs managed are substantial. We have assumed that, firstly, firms will use additional own funds instead of PII to meet this requirement; and, secondly, we will not let a firm use the lower percentage for the calculation of the requirement.¹¹ The total capital shortfall due to this requirement is approximately £104.1 million for firms subject to BIPRU but there is no capital shortfall for firms subject to IPRU(INV) Chapter 5. More information on our analysis of these firms is in Table 5.

Venture capital firms

36. We reviewed the venture capital (CAD exempt) firms subject to IPRU(INV) 5.2.3R(2), which sets a £5,000 capital requirement. Many large firms already hold own funds that are significantly greater than AIFMD levels. However, for other firms, we have calculated a total capital shortfall of approximately £31.6m under the AIFMD. Like for other firm categories, the professional negligence requirement will be new and, on an aggregate basis, firms would have to increase own funds by approximately £7m to meet it. More information on our analysis of the population is in Table 5.

Internally managed investment trusts

37. We analysed the latest balance sheets of eight internally managed above-threshold investment trusts based on their reported assets under management. As these investment trusts are large active investors, they tend to have large amounts of cash and cash equivalents on the balance sheet, as well as substantial equity (an approximation for own funds). The AIFMD capital

¹¹ This is likely to be allowed for by the Level 2 Regulation, but we propose that it would not be cost-effective to allow a firm to use this.

requirements for these firms, including additional own funds for the professional negligence requirements of Article 9(7) (if no PII insurance is purchased), are less than the cash on their balance sheet. Based on this analysis, we do not expect a capital shortfall for this type of AIF. Please see Table 5 for our aggregate analysis of internally managed investment trusts.

UCITS firms

38. We also reviewed UCITS firms because we expect some to manage AIFs. The UCITS Directive's capital requirements are substantially similar to AIFMD, apart from the professional negligence capital requirement. For UCITS firms that will be subject to AIFMD this requirement could be substantial if the AIFMD capital AUM is substantial. Because we do not have data on these firms' AIF portfolios, we have not estimated the cost of this requirement or calculated to what extent the Article 9(6) guarantee might be usable.

Table 5: The impacts of AIFMD capital requirements

Types of AIFM by current capital category	Current FSA capital sourcebook	Number of above-threshold firms in the sample	Total AUM for above-threshold firms (£m)*	Capital shortfall (including professional negligence) (£m)	Increase in capital requirement due to professional negligence (£m)	Potential guarantee amount (Art 9(6)) (£m)
BIPRU investment firm (Managers doing MiFID business)	GENPRU/ BIPRU	675	£4,500,000	£104.1	£450	£57
Venture capital managers	IPRU (INV) Chapter 5.2.3R(2)	42	£75,000	£31.6	£7.5	£2.7
Other fund managers	IPRU (INV) Chapter 5	12	£28,000	0	£2.8	£1.0
Internally-managed investment trusts	N/A	8	£13,000	0	£1.3	N/A

* Note that these amounts have been calculated from FSA038 (Volumes and Type of Business) returns and have not been independently verified, and thus are subject to data entry errors, double-counting of assets, etc.

Liquid assets requirement

39. We also propose to apply the liquid assets requirement to UCITS firms that do not manage any AIFs even though they are not within the scope of the Directive. This requirement should apply consistently to a UCITS firm irrespective of the number of AIFs it manages,

as the risks addressed are the same. As UCITS firms are currently subject under UPRU to a similar requirement to deduct illiquid assets (which we propose to remove as part of this consultation), we expect that this requirement will not result in significant additional costs to firms.

Valuation requirements

40. AIFMD and the proposed implementing measures introduce requirements relating to the valuation of AIF assets and the calculation of net asset value (NAV) per unit or share of an AIF.¹² In addition, the legislation details a number of requirements relating to the appointment of an external valuer.¹³
41. Some AIFMs or AIFs may incur costs from these requirements, particularly associated with the requirement to appoint an external valuer (where appropriate) and ensure that it continues to meet the Directive requirements, including obtaining a written statement of the professional guarantees where valuation is performed.¹⁴
42. Approximately 55% of respondents to our survey said they are likely to incur more than minimal costs. This is consistent with the fact that the majority of respondents to the Deloitte survey indicated that the current valuation arrangements in their firms are satisfactory. Firms, however, noted that there is still uncertainty about the definition of an external valuer, so it is difficult to estimate the costs. One firm even estimated valuation fees around £20,000-£30,000 per asset. Table 6 summarises the results.

Table 6: Incremental costs to firms from valuation requirements

Requirement	Incremental costs	
	One-off	Ongoing (annual)
External valuer	£0 – £26,000	£0 – £156,000

43. Firms also mentioned significant uncertainty on how the valuation of complex and illiquid assets would work in practice, particularly for private equity and real estate firms that may not currently rely on external valuations.

¹² Article 19 (1) AIFMD and Sections IV and VIII of the ESMA advice.

¹³ The Treasury Regulations will transpose those rules relating to external valuers.

¹⁴ Article 19 (5) and (6) AIFMD.

Liquidity management requirements

44. AIFMD and the Level 2 Regulation, once adopted, include requirements on liquidity management for all open-ended AIFs and those AIFs which use leverage, for example, funds implementing global macro or commodity trading adviser (CTA) strategies.¹⁵ Additionally, there is a general requirement that AIFMs ensure consistency of the investment strategy, liquidity profile and redemption policy of each AIF.¹⁶ The requirements include:
- Implementing and maintaining systems and procedures to manage and monitor liquidity risk within the AIF and ensure that the liquidity profile of investments of the AIF complies with its underlying obligations.
 - Regularly (at least annually) conducting stress tests, under both normal and exceptional liquidity conditions.
 - Identifying and disclosing to investors the types of circumstances where liquidity management tools and arrangements (e.g. gates, suspensions, side pockets) will be used in both normal and exceptional circumstances.
45. 57% of survey respondents suggested that they will incur more than minimal costs because of this requirement (Table 7). Those firms that will not incur additional significant costs either already have compliant systems in place or were not affected due to their investment strategies.

Table 7: Incremental costs to firms from liquidity management requirements

Requirement	Incremental costs	
	One-off	Ongoing (annual)
Systems and procedures	£0 – £84,000	£0 – £125,000
Stress testing	£0 – £16,000	£0 – £24,000
Disclosure to investors	£0 – £67,000	£0 – £36,000
Total	£0 – £167,000	£0 – £185,000

Leverage requirements

46. AIFMD and the Level 2 Regulation, once adopted, include requirements on the use of leverage, particularly:
- setting out and maintaining a leverage policy;
 - calculating leverage levels of each AIF in accordance with methods set out in the Directive and implementing measures¹⁷;

¹⁵ Article 16 AIFMD.

¹⁶ Article 16(2) AIFMD.

¹⁷ These proposed calculation methods are the gross and commitment methods to be set out in the Level 2 Regulation. The AIFM will be required to carry out its calculation using both methods.

- setting a maximum level of leverage for each AIF under its management;
- disclosing the maximum leverage levels to potential investors in a given AIF and keeping investors informed on the levels of leverage used¹⁸; and
- demonstrating to the regulator that leverage levels set for each AIF are reasonable and that the AIFM complies with limits at all times.

47. Evidence from the FSA firm survey suggests that firms are likely to incur incremental compliance costs, though most respondents did not expect to make material changes to their current risk management oversight and monitoring processes and procedures (Table 8). Firms noted, however, that the impacts will depend on how prescriptive the requirements will be, and the definition of leverage.

Table 8: Incremental costs to firms from leverage requirements

Requirement	Incremental costs	
	One-off	Ongoing (annual)
Leverage policy	£0 – £8,000	£0 – £36,000
Calculating leverage levels of each AIF	£0 – £51,000	£0 – £20,000
Setting a maximum level of leverage	£0 – £12,000	£0 – £70,000
Disclosure to investors	£0 – £104,000	£0 – £34,000
Disclosure to the FCA	£0 – £11,000	£0 – £35,000
Total	£0 – £186,000	£0 – £195,000

Securitisation requirements

48. The Directive will require AIFMs investing in securitisation positions on behalf of AIFs under management to only assume exposure to tradable securities and other financial instruments based on repackaged loans if the originator, sponsor or original lender has explicitly disclosed that it will retain, on an ongoing basis, a net economic interest of not less than 5%.¹⁹
49. 32% of survey respondents indicated that they currently invest in securitisation positions, but were uncertain about the possible impacts on their business models.
50. The same requirement has been rolled out to banks as part of the Capital Requirements Directive, and to insurers and reinsurers under the Solvency II legislation. Therefore the new securities issued are likely to meet the AIFMD requirements, and the impacts on business models are likely to be low.

¹⁸ Article 23.1(a) AIFMD.

¹⁹ Article 17 AIFMD.

Transparency requirements

51. AIFMs will be required to provide or make available specified information to investors and regulators. These disclosure requirements fall into three categories: prior disclosure to investors, annual reporting to investors and reporting obligations to the FCA.²⁰ Disclosure requirements regarding liquidity management, use of leverage and risk management are covered in the respective parts of this CBA.
52. AIFMs will have to disclose certain information to investors before they invest in the AIF (or if any material changes have been made). Many firms will have to update the contents of their information for investors. However, because no particular format of disclosure is prescribed and firms will be able to carry on with their current business practice, we do not expect the requirement to impose significant costs on most firms. The cost ranges that firms identified in our survey are summarised below (Table 9).
53. AIFMs will also be required to report to the FCA regularly on each AIF under their management. The frequency of reporting is based on a number of criteria such as the AIFM's assets in AIF portfolios, the size of particular AIFs, and the investment strategy of the AIFM.

Table 9: Incremental costs to firms from disclosure to investors and reporting to FCA

Requirement	Incremental costs	
	One-off	Ongoing (annual)
Disclosure to investors*:		
– cost per AIF (£)	£0 – £5,000	£0 – £4,000
– total costs (£)	£0 – £60,000	£0 – £36,000
Reporting to FCA	£0 – £74,000	£0 – £120,000

*Note that these costs do not include the incremental costs to annual reporting, which we consider to be of minimal significance.

Remuneration requirements

54. As described in Chapter 7 of this CP, the Directive also includes requirements for the implementation of remuneration policies by AIFMs. These requirements are similar to those applicable to credit institutions and MiFID investment firms under CRD3 and the CEBS Guidelines on Remuneration Policies and Practices, which we implemented in the UK via the Remuneration Code.
55. We assessed the costs of implementing the Remuneration Code in the UK in the CBA of Consultation paper 10/19.²¹ We believe that we can broadly read across these estimates to the AIFMD requirements (see Table 10). It is also worth noting, that some future AIFMs are already subject to the Remuneration Code, though the AIFMD remuneration requirements will be stricter for the larger firms than those of the Remuneration Code.

²⁰ Articles 22-24 AIFMD.

²¹ www.fsa.gov.uk/pubs/cp/cp10_19_cba.pdf

56. As a result of our proposals in this CP, AIFMs who are members of a banking group caught by CRD3 and AIFMs doing MiFID investment business under Article 6(4) of the Directive will be subject to the remuneration regimes of both CRD3 and AIFMD. To alleviate the burden of compliance with the two regimes, we will produce guidance to the Remuneration Code to the effect that compliance with the AIFMD remuneration regime will be considered compliance with the Remuneration Code. Nevertheless, we expect some minor costs relating to the overlapping regimes, for example, at the remuneration committee of the group holding company where applicable or supervisory level of AIFMs doing MiFID investment business.

Table 10: Costs for investment managers from applying the Remuneration Code

Costs	Incremental costs	
	One-off	Ongoing (annual)
For changing: • the way remuneration policies are set; • systems and controls; • additional data collection; • reporting; and • record keeping requirements.	£0 – £300,000	£0 – £50,000
Issuing an annual remuneration statement	£0 – £100,000	£0 – £30,000
Senior management board or committee time	NA	£0 – £24,000
Enhanced risk management function	NA	£0 – £31,000
Adjusting remuneration structures	£0 – £47,000	£0 – £50,000
Average of total costs	£7,000	£4,000
Median	Minimal costs	Minimal costs

Impacts of requirements for depositaries

57. The requirements for depositaries have been mentioned in Chapter 9. In summary, AIFMs will be required to appoint a depositary to carry out cash monitoring, safe-keep assets and oversee certain operational functions. The Level 2 Regulation is expected to impose quasi-strict liability, as a result of which the depositary will be liable for the loss of financial instruments held in its custody.
58. We will also require firms wishing to carry out the regulated activity of acting as a depositary of AIFs to apply to the FCA for the relevant Part IV permissions, and hold minimum capital.
59. According to the FSA firm survey, for many AIFMs this is the area of the greatest concern from a cost perspective. A large number of AIFs (such as private equity, venture capital, and real estate funds) will have to appoint a depositary of this type for the first time. Concern

has been expressed, notably from the private equity industry, that the requirement will lead to additional costs and complexity thereby reducing competition. The difficulty in finding depositaries at a reasonable price for some types of AIF has been addressed in Chapter 9. To facilitate competition in this market, the FCA intends to permit authorised professional firms and other suitably qualified authorised firms to carry on the activity of acting as a 'PE AIF depositary' as defined in Chapter 9.

60. In terms of one-off costs, AIFMs that will have to appoint a depositary are likely to incur staff costs and costs of seeking external advice. Some respondents estimated legal costs for reviewing and negotiating depositary arrangements in the range of £50,000-£100,000. The depositaries that will have to seek new Part IV permissions or vary their existing permissions may also incur one-off costs for authorisation. Acting as a depositary of authorised funds is already a regulated activity for several firms (all of whom are members of large banking groups), we therefore do not expect them to incur significant additional costs unless they accept appointments to unauthorised funds. Firms wanting to act as PE AIF depositaries that are not currently authorised depositaries, however, will incur costs from seeking authorisation or varying their existing permissions, including FCA fees. We have not quantified these costs, as at the time this CBA was carried out there was significant uncertainty about how many firms may apply.
61. In terms of ongoing costs, AIFMs may need to hire additional staff to deal with depositary matters, such as additional reporting and systems enhancements to allow the depositary to have a full overview of the cash movements and to fulfil its oversight duties. Based on the firm survey, for larger AIFs annual costs could amount to around £80,000-£300,000.
62. The most significant costs, however, will arise from the forthcoming Level 2 Regulation that are likely to enforce quasi-strict liability provisions. AIFMs that responded to the Deloitte survey said that depositary costs are 'the most pressing concern', and 78% of respondents expected costs to be significant. Depositaries will most likely charge for the additional liabilities taken, and are likely to pass on these costs to AIFs. As a result costs for funds will increase, which will most likely translate to reduced returns for investors. In some cases, the increase in costs might make a particular strategy no longer cost effective affecting investors, AIFMs and any service providers.
63. Respondents to the FSA survey expected the costs to be significant and to affect their business models, though at the time most were not able to estimate them due to uncertainty about the Level 2 Regulation. To date few institutions had stated that they will offer depositary services and had estimated the fees. A few firms provided 'guesstimates' in the range of about 10-150 basis points (bps) of NAV, assuming fees are charged by reference to asset value or fund size. It was noted that it is hard to estimate the actual costs, as these will vary greatly depending on the nature of an AIF's investments and risk profile, and the availability of specialised depositary services. However, for some managers, the fee increases may be modest, either because their assets are less risky, do not fall under the strict liability requirement in case of loss (such as assets that cannot be held in custody) and/or there is a diverse group of depositaries vying for such business.

64. Ernst & Young's analysis for AIMA estimated that currently depositaries charge around 20-35bps of AIF NAV.²² Under a lenient regime the costs might increase by about 10-25bps, but if the liability regime is strictly enforced, the costs to AIFs in terms of fees might rise by about 100-150bps. They note that in the absence of historical loss data, the complexity and heterogeneity of different investment strategies, and potential local variation with respect to AIFMD implementation, it is hard to estimate costs.

Capital requirements for depositaries

65. Some PE AIF depositaries may incur costs from our capital requirements which are described in Chapter 9. MiFID firms that choose to become a depositary of unauthorised AIFs will not see an increase in their capital requirements from €730,000. However, PE AIF depositaries under the new PE AIF depositary model (with restrictions on their activities) will incur a lower capital requirement of €125,000. For some firms, this will be a substantial increase in capital requirement where such a firm is currently operating under the capital concession for venture capital firms (CAD exempt) in IPRU(INV) 5.3.2R(2), which sets a £5,000 requirement. However, for some CAD exempt firms, this may not result in a capital shortfall because the firm already holds sufficient capital. We have not assessed the costs to firms who may become PE AIF depositaries because of the uncertainty regarding which firms will act in this role.

Q19: Do you agree with our assessment of the impact of capital requirements for PE AIF depositaries?

Market impacts

66. AIFMD and the Level 2 Regulation, once adopted, will affect firm business models and competition in the market, and many effects are likely to arise from the specific requirements in Level 2. This section only summarises these impacts at a high level, as they have been discussed at length in other externally available publications, including the CRA report commissioned by the FSA.
67. The assessment of market impacts is partial, as it does not take into account the regulatory regime to be applied to the small firms falling below the AIFMD threshold. The analysis will therefore be updated in light of the Treasury decisions on sub-threshold regimes, which will follow from their consultation document.

Direct business model impacts

68. Neither the AIFMD, nor the Level 2 requirements, directly impose limits on investment strategies. 89% of respondents to the Deloitte survey did not expect AIFMD to impact

²² See Ernst & Young (2012) 'AIFMD: get ready for European depositary reform' ([www.ey.com/Publication/vwLUAssets/AIFMD_-_prepare_for_European_depositary_reform/\\$FILE/AIFMD_20March2012.pdf](http://www.ey.com/Publication/vwLUAssets/AIFMD_-_prepare_for_European_depositary_reform/$FILE/AIFMD_20March2012.pdf)).

the investment strategies of their funds. We expect that some firm business models will be directly affected by the delegation, marketing, remuneration, depositary rules and others.

69. The delegation provisions may impact business models, but a detailed discussion of the impact of the delegation provisions is beyond the scope of this CBA because the Level 2 Regulation has not yet been adopted.
70. Additionally, AIFMs may decide to curtail investment strategies such as certain global macro and commodity trading advisor strategies that involve extensive use of FX and interest rate derivatives. The definition of leverage in the Directive is broad and requires looking through to the nominal values of derivatives. Extensive calculation and reporting of significant leverage amounts by certain AIFs may also increase the costs of such strategies. Disclosure of new gross leverage amounts without historical numbers for comparison may also affect investor appetite in these strategies.
71. Currently some investment managers in the UK that are authorised under MiFID provide services to an UK-authorised operator. Because of the delegation provisions, some of these operators which lack investment management expertise and other substance required by the Level 2 Regulation may no longer be able to offer such services. On the other hand, those operators that can meet the delegation requirements may increase business by acting as AIFMs in some structures so that certain firms may remain MiFID-authorised rather than become AIFM-authorised.
72. Some firms are currently performing AIFM functions as well as extensive MiFID business such as brokerage activities which are beyond the permitted MiFID business in the Directive.²³ These firms will need to make changes to their business model, e.g. a separation of their 'prohibited' MiFID business from their AIFM functions, before becoming an authorised AIFM.
73. Some private equity fund managers may be affected by the prohibition against asset-stripping in Article 30 AIFMD. This provision will generally prohibit asset-stripping for a period of 24 months from non-listed companies or issuers that are controlled by an AIF or a group of AIFs. This prohibition will in particular affect the business models of firms focusing on specific private equity opportunities such as management buy-out and rescue/turnaround investments.

Competition impacts

74. Overall, the increase in compliance costs may have the effect of forcing firms to withdraw from the UK market if it is no longer profitable to operate here. Respondents to the Deloitte firm survey indicated that compliance costs are particularly likely to affect medium-sized AIFMs above the Article 3 thresholds, as compliance costs are likely to constitute a larger proportion of total costs for them compared to larger firms. This means that larger firms may have a cost advantage compared to the medium sized firms. Some

²³ Article 6(4) AIFMD

firms may decide to locate their AIFM in another jurisdiction while keeping minimum sales, marketing or other presence in the UK and EU.

75. Firms that withdraw from the UK market may move to another EU or non-EEA jurisdiction. Some respondents to our firm survey were concerned that depositary costs could force AIFMs to re-domicile to non-EEA jurisdictions.
76. Incentives to relocate will be largely affected by the regimes to be introduced in the other non-EEA countries. 66% of AIFMs that responded to the Deloitte firm survey think that AIFMD will reduce the competitiveness of the EU AIF industry.
77. Firms particularly noted Switzerland as a possible location. However, if AIFMs from non-EEA countries are to continue to serve investors from the European Member States, countries like Switzerland may have to fall in line with the AIFMD requirements once the private placement rules are abolished. In fact, Switzerland has implemented regulations that are at least equivalent with the AIFMD. Both factors may mitigate some of the potential impact on EU international competitiveness anticipated by firms. Hong Kong, Singapore, US and offshore jurisdictions may also be of interest to AIFMs seeking to relocate. Many firms currently doing AIFMD business in the EU are subsidiaries of non-EEA based groups, and these firms may have multiple options on how and where to restructure.
78. On the other hand, the UK markets for alternative investment funds may become more competitive if managers from elsewhere in the EU use the new EU marketing passport to market funds in the UK, though we do not think this is very likely. Moreover, respondents to the Deloitte survey did not think that the benefits of the passport will be sufficient to compensate for the increase in compliance costs. The UK already has a flexible private placement regime for non-UK funds targeting professional investors. Regulating previously non-regulated firms and requirements for non-EEA AIFMs may also increase barriers to entry.
79. As we explain in Chapter 9 of this paper, we propose to permit authorised professional firms and other suitably qualified authorised firms to carry on the activity of acting as a PE AIF depositary in order to facilitate competition in the market. While the capital requirements for depositaries may serve as barriers to entry for some firms, we hold that these are necessary for consumer protection.

Impact on consumers

80. The additional compliance costs are likely to be passed on to investors in the form of higher fees, but the proportion of costs passed on will depend on an AIFM's ability to absorb costs and competitive conditions in the market.
81. Due to the specific requirements that affect consumers and some firms and funds withdrawing from the market, there may be reduced choice for investors as a result of AIFMD. This may be counter-balanced by entry from other EU AIFMs and AIFs given the possibility of passporting into the UK. However, the benefit of passporting is likely to be

low as firms are mostly already able to passport or promote their products to professional investors in the UK under existing promotion rules.

Benefits

82. We hold that the benefits of AIFMD as a whole cannot be reasonably estimated due to its scale, the high-level nature of the requirements and the outstanding uncertainties about the forthcoming Level 2 Regulation. We therefore describe the benefits qualitatively.
83. The European Commission has identified a number of problems that the AIFMD is aiming to solve or mitigate. The benefits of AIFMD will therefore arise from solving these problems. In its Impact Assessment the Commission stated that the activities of an AIFM 'give rise to risks for AIF investors, counterparties, the financial markets and the wider economy over and above the investment risk that is intrinsic to any financial investment'.²⁴
84. Specifically the European Commission identified macro-prudential (systemic) risks relating in particular to the use of leverage; micro-prudential risks linked to market, liquidity, counterparty and operational risks; risks to investor protection because of inadequate disclosure and potential conflicts of interest; risks to market efficiency and integrity; and impacts on the market for corporate control and on the acquisition of control of companies by an AIFM. There will also be benefits from sharing of systemic risk information with ESMA and ESRB.
85. The possibility of passporting may allow access to the UK market by funds that were not previously easily available, though the benefits of this may be limited due to the UK's flexible private placement requirements. It would also make it easier for UK-domiciled funds and managers to access markets in other Member States. This benefit would be particularly important for real estate funds as the current market is very fragmented along national borders and passporting could give rise to significant economies of scale.
86. Although most studies have failed to show that leveraged AIFs pose a particular risk to financial stability²⁵, intervention on leverage limits will reduce the extent to which AIFs can magnify the effects of an external shock and hence contribute to the transmission of risks through the financial system. There are likely to be macroeconomic benefits associated with such a reduction which are substantial but very difficult to estimate.
87. The authorisation requirement, coupled with the additional information that AIFMs need to provide to us, could lead to benefits from improved monitoring and should allow for the identification of whether specific activities of AIFMs lead to an increase in risks to consumers.
88. The operational and transparency requirements will also increase the level of information available for smaller professional investors and should result in improved investor confidence.

²⁴ See, European Commission's impact assessment (http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_impact_assessment.pdf).

²⁵ See, for instance ECB, 'Hedge Funds and their Implications for Financial Stability' Occasional paper series no.34 August 2005.

89. Finally, higher capital requirements (or PII) for AIFMs should provide additional investor protection where losses affecting investors materialise. Similarly the prudential requirements for PE depositaries should result in additional protection for investors.

Q20: Do you agree with our analysis of costs and benefits?

Annex 2

List of consultation questions

- Q1:** Although we will return to this issue in a later consultation, once ESMA has completed its work on types of AIFM, do you have any concerns or questions regarding our approach to AIFMD scope described in this chapter?
- Q2:** Do you agree with our proposed approach to the capital and PII requirements for CPM firms and internally managed AIFs?
- Q3:** Do you agree that we should treat an AIFM that also undertakes MiFID services as a BIPRU limited licence firm (subject to the additional requirements of the Directive)?
- Q4:** Do you agree with our proposed approach to professional negligence risks and the liquid assets requirement?
- Q5:** Do you agree with our intention to apply the liquid assets requirement also to UCITS management companies that do not manage any AIFs?
- Q6:** Do you agree with the proposed changes to SUP 16.12 and that the proposed new forms and guidance notes will provide us with sufficient information to assess whether firms are complying with the capital and PII requirements?

- Q7:** Do you agree with our proposal for aligning the existing requirements under the FSA Remuneration Code with the new AIFMD remuneration rules? Do you have any specific concerns regarding:
- Our proposed treatment of AIFMs which are part of a banking group?
 - AIFMs doing MiFID investment business?
- Q8:** Are the proposed capital requirements for firms that act as depositaries for authorised AIFs fair and appropriate?
- Q9:** Do you agree with our approach permitting authorised professional firms and other suitably qualified firms to be authorised to carry on the activity of acting as a PE AIF depositary?
- Q10:** What standards should we apply to determine that a firm, which is not a professional firm, is fit and proper to perform this function?
- Q11:** Do you agree that it may be necessary or desirable for PE AIF depositaries to be able to hold financial assets in custody?
- Q12:** Do you agree with the proposed approach to setting capital requirements for firms acting as PE AIF depositaries? If not, please give reasons.
- Q13:** Should such depositaries be subject to different requirements, depending on whether or not they may hold financial instruments in custody? If so, what type of requirement would be most appropriate for these higher-risk firms: more own funds, an expenditure-based requirement, or some other method of calculation (please specify)?

- Q14:** Do you agree with our approach permitting AIF depositaries to be in the same group as the AIFM so long as Directive requirements are met?
- Q15:** What additional safeguards, if any, should there be to ensure effective management of conflicts of interest, especially in relation to custody of AIF assets?
- Q16:** Do you agree with our approach requiring UK firms providing depositary services under Article 36 to hold a Part IV permission to be an AIF depositary?
- Q17:** Do you agree that EEA credit institutions should be allowed to act as depositary to UK AIFs? If you expect to be an AIFM of UK AIFs from 2013, would you consider using such a firm as depositary?
- Q18:** Should authorised funds be excluded from this arrangement?
- Q19:** Do you agree with our assessment of the impact of capital requirements for PE AIF depositaries?
- Q20:** Do you agree with our analysis of costs and benefits?

Annex 3

Equality and Diversity Impact Assessment

1. We are required under the Equality Act 2010 to ‘have due regard’ to the need to eliminate discrimination and to promote equality of opportunity in carrying out our policies, services and functions. As part of this, we conduct an equality impact assessment to ensure that the equality and diversity implications of any new policy proposals are considered.
2. Our internal assessments suggest that our proposals do not result in direct discrimination for any of the groups with protected characteristics i.e. age, disability, gender, pregnancy and maternity, race, religion and belief, sexual orientation and transgender, nor do we believe that our proposals should give rise to indirect discrimination against any of these groups. We would nevertheless welcome any comments respondents may have on any equality issues they believe may arise.

Annex 4

Compatibility Statement

Introduction

1. In this section we describe how the proposed rules in this paper are compatible with our general duties under Section 2 of FSMA and our FSA regulatory objectives set out in Sections 3 to 6 of FSMA as well as the proposed FCA strategic and operational objectives in the Bill. This section also outlines how our proposals are consistent with the principles of good regulation (also in Section 2 of FSMA) which also must be considered. As explained in the main text of this paper we have limited discretion on the implementation of AIFMD and this is reflected in the draft rules we are proposing for consultation.

Market confidence

2. Our proposals will generally improve the quality of asset management standards. In turn, we would expect this to lead to a higher level of investor confidence.

Consumer protection

3. Transposing AIFMD into UK law provides an enhanced conduct and prudential regime with a key aim of providing greater investor protection.

Reducing financial crime

4. We would expect the draft rules to strengthen professional standards and regulatory accountability for AIFMs, depositaries and others, potentially reducing the opportunities for financial crime. However, AIFMD is not directly aimed at reducing the incidence of financial crime.

Financial stability

5. Our proposed rules for AIFMs, the funds that they manage, and depositaries are likely to improve conduct and prudential standards, reduce the risk of investor losses associated with default, limit opportunities for regulatory arbitrage, inform regulators concerning the positions and exposures taken by AIFs, and thus contribute to greater financial stability.

Compatibility with the proposed FCA statutory and regulatory objectives

6. The policy proposals and draft rules in this consultation also contribute to the proposed statutory and regulatory objectives of the FCA.

Ensuring that the relevant markets function well

7. Our proposals will generally improve the functioning of the market for asset management and depositary services. For instance, the new investor disclosure rules are likely to provide better and more consistent information to investors choosing AIFs, and AIFs passporting across Europe will compete for investors while being regulated.

Consumer protection objective

8. Please refer to paragraph 3 regarding consumer protection under the FSA objectives.

Integrity objective

9. We would expect the draft rules to strengthen professional standards and regulatory accountability for AIFMs, depositaries and others, which would increase integrity. As explained above the rules should also contribute to the stability of the financial system.

Competition objective and duty

10. We would expect that the draft rules would improve competition for certain sectors of asset management, which have been hampered by disparate operating, prudential and marketing rules both within Member States and across the EU. On the other hand, barriers to entry for providing AIFM or depositary services are likely to increase.

11. In the areas where we have discretion, we have calibrated our rules to the risks that the different activities pose bearing in mind the impact on competition.

Compatibility with the principles of good regulation

12. Section 2(3) of FSMA requires that, in carrying out our general functions, we have regard to the principles of good regulation.

The need to use our resources in the most efficient and economic way

13. This is our first Consultation Paper transposing AIFMD in the UK. This approach allows us to consult in a timely manner, providing as much clarity as possible in preparation for implementation of AIFMD. We are consulting where we have sufficient certainty to do so – on the Level 1 Directive principles. A second planned consultation provides an opportunity to determine policy options following European policy developments. Our approach to implementation is designed to ensure that we use our resources efficiently. This includes using ‘intelligent copy-out’ wherever appropriate, i.e. adhering to the wording of the Directive as closely as possible.

The responsibility of those who manage the affairs of authorised persons

14. Our proposals put responsibility on firms and their management to ensure that conduct and prudential standards such as valuation, transparency reporting, remuneration policies, etc. are properly followed.

The principle that a burden or restriction which is imposed should be proportionate to the benefits

15. Although AIFMD is mostly maximum harmonising, in the few areas where we have the option to make a discretionary decision we have taken into account the proportionality principle.

The desirability of facilitating innovation

16. Our proposals might constrain certain AIF structures such as those without depositaries, or with significant reliance on investment management delegation, etc. with a resulting impact on

innovation by firms. However, we believe that the draft rules will allow for other types of innovation within firms or their funds, such as allowing for new investment strategies.

Promoting public awareness

17. These proposals are not intended to promote public awareness.

The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom

18. The harmonised AIFMD regime across Europe aims to develop a level playing field for asset managers operating across different Member States. It also seeks to achieve consistent regulatory approaches and supervisory practices, and improved frequency and quality of disclosure.
19. Although AIFMD is mostly maximum harmonising, in the few areas where we have the option to make a discretionary decision we have taken account of the competitive implications between firms based in the UK and in other countries. In developing our proposals we have considered the implementation efforts in other Member States.

The need to minimise the adverse effects on competition

20. As explained in the CBA, our proposals may have a material impact on competition for some asset managers. However, when writing rules we have attempted to calibrate them to the risks to our objectives we have identified, bearing in mind the impacts on competition.

Why our proposals are most appropriate for the purpose of meeting our statutory objectives

21. Our proposals draw on engagement with those interested in the asset management sector. We have taken account of the feedback to DP12/1 in our further policy development. We believe the proposals described in this CP represent the most appropriate and proportionate approach to implementing AIFMD.

Compatibility with the revised principles of good regulation in FSMA as amended by the Bill

22. In carrying out its general functions the FCA must have regard to the regulatory principles set out in the Act (section 1B(5)(a) FSMA (as proposed to be amended by the Bill)).
23. In addition to having considered the current principles of good regulation, we have had regard to the principles set out in section 3B of the amended FSMA. We believe all the proposed changes are compatible with these principles.

Annex 5

European Legislative Process

1. AIFMD is one of the first European Directives required to be wholly implemented following the *de Larosière* report on financial supervision in the EU¹ and under the macro-supervisory framework of the EU System of Financial Supervision (ESFS). Each Member State's transposition must take account of the Level 1 Directive, implementing measures such as the Level 2 Regulation, mandatory and discretionary binding technical standards, and Level 3 guidelines prepared by ESMA.

Levels of EU legislation under the Treaty of Lisbon and the Treaty on the Functioning of the EU (TFEU)

Level 1 (Legislative Acts – e.g. Directives)	Framework legislation setting out the basic principles is proposed by the Commission and adopted by the European Council and European Parliament. AIFMD was agreed by the European Parliament and European Council in November 2010 and was published in the <i>Official Journal</i> in June 2011. An example is AIFMD.
Level 2 (subordinate measures)	These are delegated acts (Article 290 TFEU) or implementing acts (Article 291 TFEU) developed by the Commission on the advice of ESMA (which itself consists of EU competent authorities). These set out the measures of application of the Level 1 Directive. As with Level 2 measures before the Treaty of Lisbon came into effect, the European Parliament has the power, by simple majority, to prevent adoption of the package of measures as a whole, while the European Council (consisting of representatives of the finance ministries of Member States) may also block the package if it can achieve a qualified blocking majority of votes. An example is the Level 2 Regulation on AIFMD implementing measures.

¹ Report of the High-Level Group on Financial Supervision in the EU, 25 February 2009.

Implementation of the Alternative Investment Fund Managers Directive

Level 2 Binding Technical Standards (also a form of subordinate measures)	A Level 1 Directive may delegate to the Commission the power to adopt delegated acts or implementing acts that have been drafted by one of the ESAs. These are termed ‘regulatory technical standards’ if the delegations are made under Article 290, and ‘implementing technical standards’, if the delegations are made under Article 291. These standards should be technical, must not imply strategic decisions or policy choices and their content is delimited by the legislative acts on which they are based. After the Commission proposes RTS to the European Parliament and the Council, these two bodies may object to the RTS for up to three months. This three-month period may be extended by a further three months at the initiative of the European Parliament or Council. For ITS there is no further scrutiny by the European Parliament or the Council. An example of RTS in AIFMD is in article 4(4) on types of AIFM.
Level 3	Level 3 guidelines are one of the tools to achieve European supervisory convergence and what is termed ‘common supervisory culture’ in the internal market and the ESFS. National competent authorities must treat them on a ‘comply-or-explain’ basis. ESMA is responsible for developing and adopting guidelines on the AIFMD. An example is the draft ESMA guidelines on remuneration policies for AIFMs.
Level 4	The Commission, as the guardian of the EU Treaties, is responsible for ensuring that EU Directives are properly transposed and that EU legal requirements are then consistently applied in favour of internal market rights, pursuing enforcement action against Member States where required. Without prejudice to the Commission’s powers, the ESMA Regulation envisages that ESMA may play a role in investigating alleged breaches of EU law by competent authorities. An example is ESMA’s competent authority peer review process.

Annex 6

List of subjects to be included in our second AIFMD consultation

1. Scope issues:
 - a) Further clarifications on scope of AIFMD, subject to ESMA developments.
 - b) Regimes for sub-threshold AIFMs, including both authorised and registered AIFMs.
 - c) Authorisation/registration process for:
 - i) firms that are not full scope UK AIFMs; and
 - ii) AIFMs carrying on additional activities under Article 6(4) AIFMD.
 - d) Final transitional provisions.
2. Retail regime (Article 43 AIFMD):
 - a) regimes for NURS, QIS and UCITS schemes, including the transition from COLL to FUND; and
 - b) marketing to retail investors.
3. Regime for marketing to professional investors.
4. Further clarification on Level 2 delegation requirements, including supervisory assessment of 'letterbox entity'.
5. AIFMD provisions applicable principally to private equity fund managers.
6. Application of the Financial Services Compensation Scheme and the Financial Ombudsman Service in relation to firms within scope of AIFMD.

7. Fee-raising arrangements for firms within scope of AIFMD.
8. Reporting processes for firms within scope of AIFMD.
9. Any consequential amendments to existing rules.
10. Restructuring of Handbook rules into FUND sourcebook.
11. Transitional rule for deletion of UPRU.
12. The position for depositaries of AIFs managed by sub-threshold AIFMs.

Annex 7

Feedback on DP12/1

1. In this paper we make proposals for rules and guidance taking into account responses to some of the questions asked in DP12/1. These are tabled below.
2. We posed a number of questions in DP12/1 with the expectation that some of the Directive's implementing measures would be adopted using Level 2 Directives, giving us a margin of discretion as to how we might transpose the Level 1 requirements. However, the Commission's decision to implement most of the Level 2 measures through a directly applicable Regulation has meant that we now have no national discretion in many areas where responses to our DP questions would have shaped our approach. For this reason, we have not given feedback on every question in DP12/1.
3. Some DP questions covered matters relating to domestic UK rules but not pertaining directly to AIFM implementation. Where we have decided not to take these forward as part of our work on AIFMD implementation, we have indicated this in the relevant chapter.
4. DP12/1 questions that relate to matters listed in Annex 6 will be addressed in CP2.

Question number		Chapter where we make proposals
18	Do you have any comments on our analysis as to how we expect the capital and PII requirements to apply to the different types of firm acting as managers of AIFs?	Chapter 5
19	Do you agree that it would be appropriate to set out the requirements for UCITS firms and UCITS AIFM firms in IPRU(INV)?	Chapter 5
20	Do you expect to want to use a guarantee to meet part of the additional own funds requirement?	Chapter 5
23	Do you have any comments on the most appropriate approach to determine the prudential requirements for internally managed AIFs?	Chapter 5
24	Do you have views on the intended meaning of CAD-defined terms and our approach to incorporating them in the rules for AIFMs?	Chapter 5

Implementation of the Alternative Investment Fund Managers Directive

Question number		Chapter where we make proposals
39	Should the capital requirements for depositaries within the third bullet of paragraph 7.3 of this DP be increased and, if so, what approach should be taken? What role could insurance have in supplementing this requirement? Where the depositary is within a group, to what extent would a parent stand behind its subsidiary in the case of a default and/or loss of assets?	Chapter 9
40	Are there any bodies (e.g. lawyers, accountants or fund administrators) that intend to offer depositary services to the type of AIF in paragraph 7.7 of this DP? What would be an appropriate prudential regime for these types of depositary and what level of financial or professional guarantees should be given? Should we apply any other FSA requirements to these depositaries?	Chapter 9
45	Do you consider that those entities performing the primary depositary functions should be acting independently of the AIFM and not be part of the same group as the AIFM? What are the implications of such an interpretation?	Chapter 9
46	What is the appropriate regulatory treatment for firms that carry on one or more of the three primary depositary functions for non-EU AIFs? Are there industry codes or principles of best practice that these firms should adhere to?	Chapter 9

Appendix 1

Draft Handbook text

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE INSTRUMENT 2013

Powers exercised by the Financial Conduct Authority

- A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) the following sections of the Financial Services and Markets Act 2000 (“the Act”):
 - (a) section 137A (The FCA’s general rules);
 - (b) section 137F (General rules about remuneration);
 - (c) section 137R (General supplementary powers);
 - (d) section 139A (Power of the FCA to give guidance); and
 - (e) section 247 (Trust scheme rules); and
 - (2) regulation 6(1) of the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228).
- B. The rule-making powers referred to above are specified for the purpose of section 138G (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on *[date]*.

Making the Investment Funds sourcebook (FUND)

- D. The Financial Conduct Authority makes the rules and gives the guidance in Annex A to this instrument.

Amendments to the Handbook

- E. The modules of the FCA’s Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2) below.

(1)	(2)
Glossary of definitions	Annex B
Senior Management Arrangements, Systems and Controls sourcebook (SYSC)	Annex C
General Prudential sourcebook (GENPRU)	Annex D
Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)	Annex E
Interim Prudential sourcebook for Investment Business (IPRU(INV))	Annex F
Conduct of Business sourcebook (COBS)	Annex G

Supervision manual (SUP)	Annex H
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Notes

- F. In the Annexes to this instrument, the “notes” (indicated by “**Note:**”) are included for the convenience of readers but do not form part of the legislative text.

European Union Legislation

- G. Although European Union legislation is reproduced in this instrument, only European Union legislation printed in the paper edition of the Official Journal of the European Union is deemed authentic.

Citation

- H. This instrument may be cited as the Alternative Investment Fund Managers Directive Instrument 2013.
- I. The sourcebook in Annex A to this instrument may be cited as the Investment Funds sourcebook (FUND).

By order of the Board
[date]

Annex A

Making the Investment Funds sourcebook (FUND)

In this Annex, all of the text is new and is not underlined.

1. Introduction

[To follow]

2. Authorisation

[To follow]

3. Requirements for managers of alternative investment funds

3.1 Application

Application

- 3.1.1 G The application of this chapter is summarised in the following table; the detailed application is provided in each section.

Type of firm	Applicable sections
<i>Full scope UK AIFM of a UK AIF.</i>	All of chapter 3.
<i>Full scope UK AIFM of an EEA AIF operating from an establishment in the UK.</i>	All of chapter 3.
<i>Full scope UK AIFM of an EEA AIF operating from a branch in another EEA state.</i>	All of chapter 3 with the exception of <i>FUND 3.8</i> (Prime brokerage firms).
<i>Incoming EEA AIFM branch which manages a UK AIF.</i>	<i>FUND 3.8</i> (Prime brokerage firms).
<i>Full scope UK AIFM of a non-EEA AIF marketed in the UK.</i>	All of chapter 3.
<i>Full scope UK AIFM of a non-EEA AIF not marketed in the UK.</i>	All of chapter 3 with the exception of <i>FUND 3.3</i> (Annual report of an AIF) and <i>FUND 3.11</i> (Depositaries).

<i>Depository of a UK AIF or non-EEA AIF.</i>	<i>FUND 3.11 (Depositories).</i>
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3.2 Investor information

Application

3.2.1 R This section applies to a *full scope UK AIFM* of:

- (1) a *UK AIF*;
- (2) an *EEA AIF*; and
- (3) a *non-EEA AIF*.

Prior disclosure of information to investors

3.2.2 R An *AIFM* must, for each *AIF* that it manages, make available to *AIF* investors, in accordance with the *instrument constituting the fund*, the following information before they invest in the *AIF*, as well as any material changes to it:

- (1) (a) a description of the investment strategy and objectives of the *AIF*;
- (b) if the *AIF* is a *feeder AIF*, information on where the *master AIF* is established;
- (c) if the *AIF* is a fund of funds, information on where the underlying funds are established;
- (d) a description of the types of assets in which the *AIF* may invest;
- (e) the investment techniques that the *AIF*, or the *AIFM* on behalf of the *AIF*, may employ and all associated risks;
- (f) any applicable investment restrictions;
- (g) the circumstances in which the *AIF* may use *leverage*;
- (h) the types and sources of *leverage* permitted and the associated risks;
- (i) any restrictions on the use of *leverage* and any collateral and asset reuse arrangements; and
- (j) the maximum level of *leverage* which the *AIFM* is entitled to employ on behalf of the *AIF*;

- (2) a description of the procedures by which the *AIF* may change its investment strategy or investment policy, or both;
- (3) a description of the main legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, the applicable law and the existence or absence of any legal instruments providing for the recognition and enforcement of judgments in the territory where the *AIF* is established;
- (4) the identity of the *AIFM*, the *AIF's* *depository*, the auditor and any other service providers and a description of their duties and the investors' rights;
- (5) a description of how the *AIFM* complies with the requirements of *IPRU(INV)* 7.3.12R (Professional negligence) or *GENPRU* 2.1.67R (Requirements relevant to collective portfolio management investment firms) relating to professional liability risk;
- (6) a description of:
 - (a) any *AIFM* management function delegated by the *AIFM*;
 - (b) any safe-keeping function delegated by the *depository*;
 - (c) the identity of each delegate appointed in accordance with *FUND* 3.10 (Delegation); and
 - (d) any conflicts of interest that may arise from such delegations;
- (7) a description of the *AIF's* valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing any hard-to-value assets in accordance with *FUND* 3.9 (Valuation);
- (8) a description of the *AIF's* liquidity risk management, including the redemption rights of investors both in normal and exceptional circumstances, and the existing redemption arrangements with investors;
- (9) a description of all fees, charges and expenses and of the maximum amounts directly or indirectly borne by investors;
- (10) a description of how the *AIFM* ensures a fair treatment of investors;
- (11) whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of:
 - (a) that preferential treatment;
 - (b) the type of investors who obtain such preferential treatment;

and

- (c) where relevant, their legal or economic links with the *AIF* or *AIFM*;
- (12) the procedure and conditions for the issue and sale of *units* or *shares*;
- (13) the latest net asset value of the *AIF* or the latest market price of the *unit* or *share* of the *AIF*, in accordance with *FUND* 3.9 (Valuation);
- (14) the latest annual report made available in accordance with *FUND* 3.3 (Annual report of an *AIF*);
- (15) where available, the historical performance of the *AIF*;
- (16)
 - (a) the identity of the *prime brokerage firm*;
 - (b) a description of any material arrangements of the *AIF* with its *prime brokerage firm* and the way any conflicts of interest are managed;
 - (c) the provision in the contract with the *depository* on the possibility of transfer and reuse of *AIF* assets; and
 - (d) information about any transfer of liability to the *prime brokerage firm* that may exist; and
- (17) a description of how and when the information required under *FUND* 3.2.5R and *FUND* 3.2.6R will be disclosed.

[**Note:** article 23(1) of *AIFMD*]

- 3.2.3 R (1) An *AIFM* must inform investors before they invest in the *AIF* of any arrangement made by the *depository* to contractually discharge itself of liability in accordance with regulation [x] of the *AIFMD UK Regulation*.
- (2) The *AIFM* must also inform investors without delay of any changes with respect to *depository* liability.

[**Note:** article 23(2) of *AIFMD*]

- 3.2.4 R Where the *AIF* is required to publish a *prospectus* in accordance with section 85 of the *Act* or the equivalent provision implementing article 3 of the *Prospectus Directive* in the *AIF's Home State*, only such information referred to in *FUND* 3.2.2R and 3.2.3R that is additional to that contained in the *prospectus* needs to be disclosed, either separately or as additional information in the *prospectus*.

[**Note:** article 23(3) of *AIFMD*]

Periodic disclosure

- 3.2.5 R An *AIFM* must, for each *AIF* that it manages, disclose to investors periodically:
- (1) the percentage of the *AIF*'s assets that are subject to special arrangements arising from their illiquid nature;
 - (2) any new arrangements for managing the liquidity of the *AIF*; and
 - (3) the current risk profile of the *AIF* and the risk management systems employed by the *AIFM* to manage those risks.

[**Note:** article 23(4) of *AIFMD*]

- 3.2.6 R An *AIFM* that manages an *AIF* employing *leverage* must, for each such *AIF*, disclose on a regular basis:
- (1) any changes to:
 - (a) the maximum level of *leverage* that the *AIFM* may employ on behalf of the *AIF*; and
 - (b) any right of reuse of collateral or any guarantee granted under the *leveraging* arrangement; and
 - (2) the total amount of *leverage* employed by that *AIF*.

[**Note:** article 23(5) of *AIFMD*]

Subordinate measures

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing this section]

3.3 Annual report of an AIF

Application

- 3.3.1 R This section applies to a *full scope UK AIFM* of:
- (1) a *UK AIF*;
 - (2) an *EEA AIF*; and
 - (3) a *non-EEA AIF* marketed in the *United Kingdom*.

Provision of an annual report

- 3.3.2 R An *AIFM* must, for each *UK AIF* and *EEA AIF* it manages and for each *non-EEA AIF* it markets in the *United Kingdom*:

- (1) make an annual report available to investors for each financial year;
- (2) provide the annual report to investors on request; and
- (3) make the annual report available to the *FCA* and, in the case of an *EEA AIF*, to the *Home State competent authority* of that *AIF*.

[**Note:** article 22(1) first paragraph and article 24(3)(a) of *AIFMD*]

- 3.3.3 R An *AIFM* must make the annual report available, in accordance with *FUND* 3.3.2R(1), no later than six months after the end of the financial year.

[**Note:** article 22(1) first paragraph of *AIFMD*]

- 3.3.4 R (1) Where the *AIF* is required to make public an annual financial report in accordance with *DTR* 4.1.3R (Publication of annual financial reports) or the equivalent provision implementing article 4.1 of the *Transparency Directive* in the *Home State* of the *AIF*, only such information referred to in *FUND* 3.3.5R that is additional to the annual financial report needs to be provided to investors on request, either separately or as an additional part of the annual financial report.
- (2) Where the additional information referred to in (1) is provided as an additional part of the annual financial report, that report must be made public no later than four months following the end of the financial year, in accordance with *DTR* 4.1.3R (Publication of annual financial reports) or the equivalent provision implementing article 4.1 of the *Transparency Directive* in the *Home State* of the *AIF*.

[**Note:** second paragraph, article 22(1) of *AIFMD*]

Contents of the annual report

- 3.3.5 R The annual report must contain:
- (1) a balance sheet or a statement of assets and liabilities;
 - (2) an income and expenditure account for the financial year;
 - (3) a report on the activities of the financial year;
 - (4) any material changes in the information required to be made available to investors under *FUND* 3.2.2R (Prior disclosure of information to investors) during the financial year covered by the report;
 - (5) (a) the total amount of *remuneration* paid by the *AIFM* to its staff for the financial year, split into fixed and variable remuneration, including, where relevant, any *carried interest* paid by the *AIF*; and
 - (b) the number of beneficiaries; and

- (6) the aggregate amount of *remuneration* of the *AIFM Remuneration Code staff*, broken down by senior management and members of staff.

[**Note:** article 22(2) of *AIFMD*]

Accounting information in the annual report

- 3.3.6 R The accounting information given in the annual report must be:
 - (1) prepared in accordance with the accounting standards of the *Home State* of the *AIF* (or, for a *non-EEA AIF*, in accordance with the accounting standards of the third country where it is *established*) and with the accounting rules laid down in the *AIF's instrument constituting the fund*; and
 - (2) audited by one or more persons empowered by law to audit accounts in accordance with the *Audit Directive* (or for a *non-EEA AIF*, audited in accordance with international auditing standards in force in the country where the *non-EEA AIF* is *established*).

[**Note:** article 22(3) of *AIFMD*]

- 3.3.7 R The auditor's report, including any qualifications, must be reproduced in full in the annual report.

[**Note:** second paragraph article 22(3) of *AIFMD*]

Subordinate measures

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing this section]

3.4 Reporting obligations to the FCA

Application

- 3.4.1 R This section applies to a *full scope UK AIFM* of:
 - (1) a *UK AIF*;
 - (2) an *EEA AIF*; and
 - (3) a *non-EEA AIF*.

Reporting obligations

- 3.4.2 R An *AIFM* must regularly report to the *FCA* on behalf of each of the *AIFs* it manages on:
 - (1) the main instruments in which it is trading;

- (2) the principal markets of which it is a member or where it actively trades; and
- (3) the principal exposures and most important concentrations of each *AIF* it manages.

[**Note:** article 24(1) of *AIFMD*]

- 3.4.3 EU [Relevant provision of the *AIFMD level 2 regulation* to be inserted which supplements the requirements regarding frequency of reporting]

Content of reporting information

- 3.4.4 R An *AIFM* must, for each *AIF* it manages, provide the following to the *FCA*:
- (1) the percentage of the *AIF*'s assets that are subject to special arrangements arising from their illiquid nature;
 - (2) any new arrangements for managing the liquidity of the *AIF*;
 - (3) the current risk profile of the *AIF* and the risk management systems employed by the *AIFM* to manage the *market risk*, *liquidity risk*, *counterparty risk* and other risks, including *operational risk*;
 - (4) information on the main categories of assets in which the *AIF* is invested; and
 - (5) the results of the stress tests performed in accordance with *FUND* 3.6.3R(2) (Liquidity systems and procedures) and *FUND* 3.7.5R(2)(b) (Risk management systems).

[**Note:** article 24(2) of *AIFMD*]

- 3.4.5 R An *AIFM* must, on request of the *FCA*, provide at the end of each quarter a detailed list of all *AIFs* which the *AIFM* manages.

[**Note:** article 24(3)(b) of *AIFMD*]

AIFs that employ leverage on a substantial basis

- 3.4.6 R An *AIFM* managing an *AIF* that employs *leverage* on a substantial basis must make the following information available to the *FCA* about that *AIF*:
- (1) the overall level of *leverage* employed by the *AIF*;
 - (2) a breakdown of *leverage* arising from borrowing of cash or *securities* and *leverage* embedded in financial *derivatives*;
 - (3) the extent to which the *AIF*'s assets have been reused under *leveraging* arrangements; and

- (4) the identity of the five largest sources of borrowed cash or *securities* for the *AIF*, and the amounts of *leverage* received from each of those sources for the *AIF*.

[**Note:** article 24(4) of *AIFMD*]

Meaning of employing leverage on a substantial basis

- 3.4.7 EU [Relevant provision of the *AIFMD level 2 regulation* to be inserted which supplements the meaning of employing leverage on a substantial basis]

Notification of material changes

- 3.4.8 R Where an *AIFM* proposes to make any material changes to the conditions for initial authorisation, in particular in respect of the information which it has provided to the *FCA* when applying for a *Part IV permission* to *manage an AIF*, the *AIFM* must notify the *FCA* before implementing those changes.

[**Note:** article 10(1) of *AIFMD*]

Subordinate measures

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing this section]

3.5 Investment in securitisation positions

Subordinate measures

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing the provisions in *AIFMD* on investment in securitisation positions]

3.6 Liquidity

Application

- 3.6.1 R This section applies to a *full scope UK AIFM* of:
- (1) a *UK AIF*;
 - (2) an *EEA AIF*; and
 - (3) a *non-EEA AIF*.

Alignment of investment strategy, liquidity profile and redemption policy

- 3.6.2 R An *AIFM* must ensure that the investment strategy, liquidity profile and redemption policy of each *AIF* it manages are consistent.

[**Note:** article 16(2) of *AIFMD*]

Liquidity systems and procedures

- 3.6.3 R An *AIFM* must, for each *AIF* it manages that is not an unleveraged closed-ended *AIF*:
- (1) employ an appropriate liquidity management system and adopt procedures which:
 - (a) enable it to monitor the *liquidity risk* of the *AIF*; and
 - (b) ensure that the liquidity profile of the investments of the *AIF* complies with the *AIF*'s underlying obligations; and
 - (2) regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable it to assess the *liquidity risk* of the *AIF* and monitor that risk accordingly.

[**Note:** article 16(1) of *AIFMD*]

Subordinate measures

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing this section]

3.7 Risk management

Application

- 3.7.1 R This section applies to a *full scope UK AIFM* of:
- (1) a *UK AIF*;
 - (2) an *EEA AIF*; and
 - (3) a *non-EEA AIF*.

Functional and hierarchical separation

- 3.7.2 R
- (1) An *AIFM* must functionally and hierarchically separate the functions of risk management from the operating units, including from the functions of portfolio management.
 - (2) An *AIFM* must, in any event, be able to demonstrate that:
 - (a) specific safeguards against conflicts of interest allow for the independent performance of risk management activities; and
 - (b) the risk management process satisfies the requirements of

this section and is consistently effective.

[**Note:** article 15(1) of *AIFMD*]

- 3.7.3 EU [Relevant provision of the *AIFMD level 2 regulation* to be inserted which supplements the meaning of functional and hierarchical separation]
- 3.7.4 EU [Relevant provision of the *AIFMD level 2 regulation* to be inserted which supplements the meaning of specific safeguards against conflicts of interest]

Risk management systems

- 3.7.5 R (1) An *AIFM* must implement adequate risk management systems to identify, measure, manage and monitor all risks relevant to each *AIF* investment strategy and to which each *AIF* is or may be exposed.
- (2) An *AIFM* must, at least:
- (a) implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the *AIF*, according to the investment strategy, objectives and risk profile of the *AIF*;
 - (b) ensure that the risks associated with each investment position of the *AIF* and their overall effect on the *AIF*'s portfolio can be properly identified, measured, managed and monitored on an ongoing basis, including through the use of appropriate stress testing procedures; and
 - (c) ensure that the risk profile of the *AIF* corresponds to the size, portfolio structure and investment strategies and objectives of the *AIF* as laid down in the *instrument constituting the fund, prospectus* and offering documents.

[**Note:** article 15(2) first paragraph and article 15(3) of *AIFMD*]

Review of risk management systems

- 3.7.6 R An *AIFM* must:
- (1) review the risk management systems with appropriate frequency and, in any event, at least once a year; and
 - (2) adapt them whenever necessary.

[**Note:** article 15(2) second paragraph of *AIFMD*]

Maximum leverage levels

- 3.7.7 R (1) An *AIFM* must:
- (a) set a maximum level of *leverage* which it may employ on

behalf of each *AIF* it manages; and

- (b) where the *leveraging* arrangement allows the right to reuse *collateral* or the granting of a guarantee, set out the extent of that right or guarantee.
- (2) An *AIFM*, in complying with (1), must take into account relevant matters including:
- (a) the type of *AIF*;
 - (b) the investment strategy of the *AIF*;
 - (c) the sources of *leverage* of the *AIF*;
 - (d) any other link or relevant relationship with other financial services institutions which could pose systemic risk;
 - (e) the need to limit the exposure to any single counterparty;
 - (f) the extent to which the *leverage* is collateralised;
 - (g) the asset-liability ratio; and
 - (h) the scale, nature and extent of the activity of the *AIFM* on the markets concerned.

[**Note:** article 15(4) of *AIFMD*]

- 3.7.8 R An *AIFM* must demonstrate that the *leverage* limits it sets in accordance with *FUND* 3.7.7R(1)(a) are reasonable and that it complies with those limits at all times.

[**Note:** article 25(3) first sentence of *AIFMD*]

- 3.7.9 G In order to comply with *FUND* 3.7.8R, an *AIFM* should report to the *FCA* any changes to the *leverage* limits it sets.

Subordinate measures

[**Note:** articles [x] to [y] and articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing the provisions in this section on the calculation of levels of leverage and on risk management]

3.8 Prime brokerage firms

Application

- 3.8.1 R This section applies to:

- (1) a *full scope UK AIFM* of:
 - (a) a *UK AIF*;
 - (b) an *EEA AIF* managed or *marketed* from an establishment in the *United Kingdom*; and
 - (c) a *non-EEA AIF*; and
- (2) an *incoming EEA AIFM branch* which manages or *markets* a *UK AIF*.

Selection of a prime brokerage firm

- 3.8.2 R An *AIFM* must exercise due skill, care and diligence in the selection and appointment of a *prime brokerage firm*.

[**Note:** article 14(3) second paragraph of the *AIFMD*]

Prime brokerage firm contract

- 3.8.3 R Where the *AIFM*, on behalf of an *AIF*, uses the services of a *prime brokerage firm*, the terms must be set out in a written contract. In particular, any possibility of transfer and reuse of *AIF* assets must be provided for in that contract and must comply with the *AIF's instrument constituting the fund*. The contract must provide for the *depository* to be informed of the contract.

[**Note:** article 14(3) first paragraph of the *AIFMD*]

3.9 Valuation

Application

- 3.9.1 R This section applies to a *full scope UK AIFM* of:
- (1) a *UK AIF*;
 - (2) an *EEA AIF*; and
 - (3) a *non-EEA AIF*.

Responsibility of the AIFM

- 3.9.2 R An *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.

[**Note:** article 19(10) first sentence first paragraph of *AIFMD*]

Standard of care of the valuation

- 3.9.3 R An *AIFM* must ensure that any valuation of an *AIF*'s assets is performed impartially and with all due skill, care and diligence.

[**Note:** article 19(8) of *AIFMD*]

Establishment of procedures for valuation of assets

- 3.9.4 R An *AIFM* must ensure that, for each *AIF* it manages, appropriate and consistent procedures are established so that in accordance with rules laid down in the applicable national law of the country where the *AIF* is established and the *instrument constituting the fund*:

- (1) a proper and independent valuation of the assets of the *AIF* can be performed; and
- (2) the net asset value per *unit* or *share* of the *AIF* is calculated and disclosed to investors.

[**Note:** article 19(1), (2) and (3) first paragraph of *AIFMD*]

Frequency of valuation of assets and calculation of net asset value

- 3.9.5 R
- (1) An *AIFM* must ensure that the valuation procedure referred to in *FUND* 3.9.4R provides for the assets of any *AIF* under the *AIFM*'s management to be valued and the net asset value per *unit* or *share* to be calculated at least once a year.
 - (2) Where an *AIF* is open-ended, such valuations and calculations must also be carried out at a frequency that is appropriate both to the assets held by the *AIF* and its issuance and redemption frequency.
 - (3) Where an *AIF* is closed-ended, such valuations and calculations must also be carried out in case of an increase or decrease of the capital by the relevant *AIF*.

[**Note:** article 19(3) second, third and fourth paragraphs of *AIFMD*]

Informing investors of valuations of assets and calculations of net asset value

- 3.9.6 R An *AIFM* must ensure that investors in the *AIFs* under its management are informed of the valuations and calculations in the manner set out in the relevant *instrument constituting the fund*.

[**Note:** article 19(3) fifth paragraph of *AIFMD*]

Performance of the valuation function

- 3.9.7 R
- (1) An *AIFM* may perform the valuation itself, provided that:
 - (a) the valuation task is functionally independent from the portfolio management; and

- (b) the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon the employees involved is prevented.
- (2) An *AIFM* that does not perform the valuation function itself must ensure that the function is performed by an external valuer.
- (3) An external valuer appointed under (2) must be a person independent from:
 - (a) the *AIF* in respect of which the valuation function is performed;
 - (b) the *AIFM*; and
 - (c) any other persons with *close links* to the *AIF* or the *AIFM*.

[**Note:** article 19(4) first paragraph of *AIFMD*]

Appointment of the depositary as an external valuer

- 3.9.8 R The *depositary* appointed for an *AIF* may not be appointed as an external valuer of that *AIF* unless:
- (1) it has functionally and hierarchically separated the performance of its depositary functions from its tasks as an external valuer; and
 - (2) the potential conflicts of interests are properly identified, managed, monitored and disclosed to the investors of the *AIF*.

[**Note:** article 19(4) second paragraph of *AIFMD*]

Appointment of an external valuer

- 3.9.9 R Where an external valuer performs the valuation function, the *AIFM* must be able to demonstrate that:
- (1) the external valuer is subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct;
 - (2) the external valuer can provide sufficient professional guarantees to be able to perform the relevant valuation function effectively in accordance with this section;
 - (3) the appointment of the external valuer complies with the requirements of *FUND* 3.10.2R (General delegation arrangements) and the *AIFMD level 2 regulation*.

[**Note:** article 19(5) of *AIFMD*]

Delegation by an external valuer

- 3.9.10 G *AIFMs* should be aware that regulation [x] of the *AIFMD UK regulation* prohibits an external valuer from delegating valuation to a third party.

Notification of appointment of an external valuer

- 3.9.11 R An *AIFM* must notify the appointment of an external valuer to the *FCA*.

[**Note:** article 19(7) first part of first paragraph of *AIFMD*]

- 3.9.12 G In accordance with regulation [x] of the *AIFMD UK Regulation* the *FCA* may require an *AIFM* to appoint another external valuer where it considers that the appointment does not comply with *FUND* 3.9.9R.

Subordinate measures

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing this section]

3.10 Delegation

Application

- 3.10.1 R This section applies to a *full scope UK AIFM* of:

- (1) a *UK AIF*;
- (2) an *EEA AIF*; and
- (3) a *non-EEA AIF*,

in relation to the delegation of those *AIFM management functions* for which it is responsible, other than supporting tasks such as administrative or technical functions.

[**Note:** recital 31 of *AIFMD*]

General delegation requirements

- 3.10.2 R An *AIFM* must ensure the following conditions are met when a delegate carries out any function on its behalf:

- (1) the *AIFM* has notified the *FCA* of the delegation before the delegation arrangements become effective; and
- (2)
 - (a) the *AIFM* is able to justify its entire delegation structure with objective reasons;
 - (b) the delegate has sufficient resources to perform the respective activity and the persons who effectively conduct the business of the delegate are of sufficiently good reputation and sufficiently

experienced;

- (c) (subject to *FUND 3.10.7R*) the delegation of *AIFM investment management functions* are conferred only on a delegate that is authorised or registered for the purpose of asset management and subject to supervision;
- (d) in addition to the requirements in (c), where the delegation of *AIFM investment management functions* are conferred on a third-country delegate, cooperation between the *FCA* and the supervisory authority of the delegate is ensured;
- (e) the delegation does not prevent the *FCA* from supervising the *AIFM* effectively and, in particular, does not prevent the *AIFM* from acting, or the *AIF* from being managed, in the best interests of its investors; and
- (f) the *AIFM* is able to demonstrate that:
 - (i) the delegate is qualified and capable of undertaking the functions in question;
 - (ii) it was selected with all due care; and
 - (iii) the *AIFM* is in a position to monitor the delegated activity effectively at any time, to give further instructions to the delegate at any time, and to withdraw the delegation with immediate effect when this is in the interest of investors.

[**Note:** article 20(1) of *AIFMD*]

- 3.10.3 G For the purposes of *FUND 3.10.2R(2)(d)* cooperation is ensured between the *FCA* and the supervisory authorities of a third country delegate where there is a cooperation arrangement in place between the two authorities in accordance with the provisions of *AIFMD* and the *AIFMD level 2 regulation*.

Sub-delegation

- 3.10.4 R An *AIFM* must ensure the following conditions are met when any of its delegates carries out a sub-delegation:
- (1) the *AIFM* has consented to the sub-delegation before the sub-delegation arrangements become effective;
 - (2) the *AIFM* has notified the *FCA* of the sub-delegation before the sub-delegation arrangements become effective; and
 - (3) the conditions set out in *FUND 3.10.2R(2)* (General delegation requirements) are satisfied in relation to the sub-delegation with references to ‘delegate’ and ‘delegation’ replaced by references to

‘sub-delegate’ and ‘sub-delegation’.

[**Note:** article 20(4) of *AIFMD*]

- 3.10.5 R An *AIFM* must comply with the *rules* set out in this section which are applicable to a sub-delegation in relation to any further sub-delegation of its functions by a sub-delegate.

[**Note:** article 20(6) of *AIFMD*]

Delegation of *AIFM* investment management functions

- 3.10.6 R An *AIFM* must not delegate or consent to the sub-delegation of *AIFM investment management functions* to:
- (1) the *depository* or a delegate of the *depository*; or
 - (2) any other entity whose interests may conflict with those of the *AIFM* or the investors of the *AIF*, unless:
 - (a) that entity has functionally and hierarchically separated the performance of its *AIFM investment management function* from its other potentially conflicting tasks; and
 - (b) the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the *AIF*.

[**Note:** article 20(2) and (5) of *AIFMD*]

- 3.10.7 R An *AIFM* may delegate, or consent to the sub-delegation of, *AIFM investment management functions* to an entity which is not authorised or registered for the purpose of asset management and subject to supervision as required by *FUND* 3.10.2R(2)(c) if this is approved by the *FCA* beforehand in accordance with regulation [x] of the *AIFMD UK regulation*.

[**Note:** article 20(1)(c) of *AIFMD*]

Letterbox entity

- 3.10.8 R An *AIFM* must not delegate its functions to the extent that, in essence, it can no longer be considered to be the *AIFM* of the *AIF* and to the extent that it becomes a letter-box entity.

[**Note:** article 20(3) of *AIFMD*]

- 3.10.9 EU [Relevant provisions of the *AIFMD level 2 regulation* to be inserted which supplements the meaning of letterbox entity]

Liability for delegated functions

- 3.10.10 G An *AIFM*'s liability towards the *AIF* and its investors should not be affected

by the fact that the *AIFM* has delegated functions to a third party, or by any further sub-delegation as set out in regulation [x] of the *AIFMD UK regulation*.

[**Note:** article 20(3) of *AIFMD*]

Review of delegation and sub-delegation

3.10.11 R An *AIFM* must review on an ongoing basis the services provided by each:

- (1) delegate appointed under *FUND* 3.10.2R; and
- (2) sub-delegate appointed under *FUND* 3.10.4R.

[**Note:** article 20(1) and 20(4) of *AIFMD*]

3.10.12 G An *AIFM* should make each of its delegates aware of the requirement to review the services provided by each of its sub-delegates on an ongoing basis in accordance with regulation [x] of the *AIFMD UK regulation*.

Subordinate measures

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing this section]

3.11 Depositories

Application

3.11.1 R This section applies in accordance with the table in *FUND* 3.11.2R.

3.11.2 R This table belongs to *FUND* 3.11.1.

<i>Rule</i>	<i>Full scope UK AIFM of a UK AIF or an EEA AIF</i>	<i>Full scope UK AIFM of a non-EEA AIF which is marketed in the UK</i>	<i>UK depository of a UK AIF</i>	<i>UK depository of a non-EEA AIF</i>
3.11.3R	x			
3.11.4R	x		x	
3.11.6R	x			
3.11.8R			x	
3.11.9R	x			

3.11.10R	x			
3.11.11R	x			
3.11.13R			x	
3.11.15R	x			
3.11.16R	x		x	
3.11.17R			x	x
3.11.18R			x	x
3.11.20R			x	x
3.11.21R			x	
3.11.22R			x	x
3.11.23R			x	
3.11.25R			x	
3.11.26R			x	
3.11.29R			x	
3.11.30R		x		
Note: "x" means "applies", but not every paragraph in every <i>rule</i> will necessarily apply.				

Appointment of a single depositary

- 3.11.3 R An *AIFM* must, for each *AIF* it manages, ensure that:
- (1) a single *depositary* is appointed; and
 - (2) the assets of the *AIF* are entrusted to the *depositary* for safekeeping in accordance with *FUND* 3.11.18R and *FUND* 3.11.20R.

[**Note:** article 21(1) and 21(8) of *AIFMD*]

General obligations

- 3.11.4 R An *AIFM* and a *depositary* must, in the context of their respective roles, act honestly, fairly, professionally, independently and in the interest of the *AIF* and its investors.

[**Note:** article 21(10) first paragraph of *AIFMD*]

- 3.11.5 G The *Act* specifies that the *trustee* of an *AUT* must be independent of its *manager*, and the *OEIC Regulations* specify that the *depository* of an *ICVC* must be independent of the *ICVC* and its *directors*. *FUND* [4.x] sets out the *FCA*'s view of how those independence requirements should be interpreted for *authorised funds*. These requirements do not apply to *AIFs* which are not *authorised funds*, and, therefore, an *AIFM* and a *depository* of an *unauthorised AIF* may be from within the same *group*, but only if conflicts of interest are avoided in accordance with the provisions of *FUND* 3.11.6R and there is sufficient organisational separation between the two entities.

Conflicts of interest: *AIFM*

- 3.11.6 R In order to avoid conflicts of interest between the *depository*, the *AIFM*, the *AIF* and its investors, an *AIFM* must ensure that:
- (1) it does not act as a *depository* or a delegate of a *depository*; and
 - (2) a *prime brokerage firm* acting as counterparty to an *AIF* does not act as the *depository* for that *AIF*, unless:
 - (a) the *prime brokerage firm* has functionally and hierarchically separated the performance of its *depository* functions from its tasks as a *prime brokerage firm*; and
 - (b) potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the *AIF* by the *AIFM*.

[**Note:** article 21(4) of *AIFMD*]

- 3.11.7 G A *depository* should be able to delegate custody tasks to one or more *prime brokerage firms* provided the *depository* complies with *FUND* 3.11.23R to *FUND* 3.11.27R. In addition to the delegated custody tasks, *prime brokerage firms* should be allowed to provide *prime brokerage services* to the *AIF*. Those *prime brokerage services* should not form part of the delegation arrangement.

[**Note:** recital 43 of *AIFMD*]

Conflicts of interest: *depositories*

- 3.11.8 R A *depository* must not carry out activities with regard to the *AIF*, or the *AIFM* on behalf of the *AIF*, that may create conflicts of interest between the *AIF*, the investors in the *AIF*, the *AIFM* and itself, unless the *depository*:
- (1) has properly identified any such potential conflicts of interest;
 - (2) has functionally and hierarchically separated the performance of its *depository* tasks from its other potentially conflicting tasks; and
 - (3) the potential conflicts of interest are properly managed, monitored

and disclosed to the investors of the *AIF*.

[**Note:** article 21(10) second paragraph of *AIFMD*]

Eligible depositaries for UK AIFs

- 3.11.9 R Subject to *FUND* 3.11.10R, an *AIFM* must, for each *UK AIF* it manages, ensure the appointment of a *depositary* which is a *firm established* in the *United Kingdom* and which is one of the following:
- (1) a *credit institution*; or
 - (2) a *full scope BIPRU investment firm* which:
 - (a) is a *BIPRU 730k firm*; and
 - (b) provides the *ancillary service* of safe-keeping and administration of *financial instruments* for the account of clients; or
 - (3) another category of institution that is subject to prudential regulation and ongoing supervision and which, on 21 July 2011, fell within the categories of institution eligible to be a *trustee* of an *AUT* or a *depositary* of an *ICVC*.

[**Note:** article 21(3)(a) to (c) and 21(5)(a) of *AIFMD*]

PE AIF depositaries

- 3.11.10 R An *AIFM* that manages an *AIF* which:
- (1) has no redemption rights exercisable during the period of five years from the date of the initial investments; and
 - (2) in accordance with its core investment policy, generally:
 - (a) does not invest in *AIF custodial assets*; or
 - (b) invests in *issuers* or *non-listed companies* in order to potentially acquire control over such companies in accordance with regulation [x] of the *AIFMD UK regulation*,

may appoint as its *depositary* a *firm* which is *established* in the *United Kingdom* and which complies with *FUND* 3.11.11R.

- 3.11.11 R An *AIFM* must ensure that a *depositary* appointed in accordance with *FUND* 3.11.10R:
- (1) is a *firm* with a *Part IV permission* to act as *depositary* of an *AIF*; and
 - (2) complies with the capital requirement in *IPRU(INV)* 5.2.3R(3)(a)(ia)

(Own funds requirement).

[**Note:** article 21(3) second paragraph after (c) and 21(5)(a) of *AIFMD*]

- 3.11.12 G For certain types of closed-ended *AIFs*, such as private equity, venture capital funds and real estate funds, a wider range of entities than those specified in *FUND* 3.11.9R, such as *authorised professional firms*, should be able to perform the relevant *depository* functions. The *FCA* requires such entities to obtain authorisation as a *depository* in order to demonstrate that they can meet the commitments inherent in those functions, but imposes a lower level of capital requirements in recognition of the different nature of the duties implied by the characteristics of the *AIF*, especially in relation to custody risk.

[**Note:** recital 34 of *AIFMD*]

Additional requirements for depositaries of authorised *AIFs*

- 3.11.13 R A *full scope BIPRU investment firm* which is appointed as a *depository* for an *authorised AIF* in accordance with *FUND* 3.11.9R(2) must maintain *own funds* of at least £4 million.
- 3.11.14 G A *full scope BIPRU investment firm* which is a *depository* for an *authorised AIF* is subject to the capital requirements of *GENPRU* and *BIPRU*. However, these requirements are not in addition to *FUND* 3.11.13R, and, therefore, a *firm* subject to this *rule* may use the *own funds* required under *GENPRU* and *BIPRU* to meet the £4 million requirement.

Eligible depositaries for EEA *AIFs*

- 3.11.15 R An *AIFM* must, for each *EEA AIF* it manages, ensure the appointment of a *depository* which is *established* in the *Home State* of the *AIF* and which is eligible to be a *depository* in that *Home State* in accordance with the provisions of article 21(3) of *AIFMD*.

[**Note:** article 21(3) and 21(5)(a) of *AIFMD*]

Written contract

- 3.11.16 R An *AIFM* and a *depository* must ensure that the appointment of the *depository* is evidenced by a written contract. The contract must regulate the flow of information deemed necessary to allow the *depository* to perform its functions for the *AIF* for which it has been appointed as *depository*.

[**Note:** article 21(2) of *AIFMD*]

Depository functions: cash monitoring

- 3.11.17 R A *depository* must ensure that the *AIF's* cash flows are properly monitored and that:
- (1) all payments made by, or on behalf of, investors upon the

- subscription of *units* or *shares* of an *AIF* have been received;
- (2) all cash of the *AIF* has been booked in cash accounts opened:
- (a) in the name of:
- (i) the *AIF*; or
 - (ii) the *AIFM* acting on behalf of the *AIF*; or
 - (iii) the *depository* acting on behalf of the *AIF*; and
- (b) at:
- (i) an entity referred to CASS 7.4.1R(1) to (3) (Depositing client money); or
 - (ii) another entity of the same nature, in the relevant market where cash accounts are required, provided that such entity is subject to effective prudential regulation and supervision which have the same effect as *EU* law and are effectively enforced and in accordance with the principles set out in article 16 (safeguarding of client financial instruments and funds) of the *MiFID Implementing Directive*; and
- (3) where cash accounts are opened in the name of the *depository* acting on behalf of the *AIF* in accordance with (2)(a)(iii), a *depository* must ensure that no cash of the entity referred to in (2)(b), and none of the *depository*'s own cash, is booked on such accounts.

[**Note:** article 21(7) of *AIFMD*]

Depository functions: safekeeping of financial instruments

- 3.11.18 R (1) A *depository* must hold in custody all *AIF custodial assets*.
- (2) The *depository* must ensure that all *AIF custodial assets* that can be registered in a *financial instruments* account are registered in the *depository*'s books within segregated accounts opened in the name of the *AIF*, or the *AIFM* acting on behalf of the *AIF*, so that they can be clearly identified as belonging to the *AIF* at all times in accordance with the applicable law and the principles set out in CASS 6.2.2R (Requirement to have adequate organisational arrangements), CASS 6.3.1R (Depositing assets and arranging for assets to be deposited with third parties), CASS 6.5.1R and CASS 6.5.2R (Records and accounts), and CASS 6.5.6R (Reconciliations with external records).

[**Note:** article 21(8)(a) of *AIFMD*]

- 3.11.19 EU [Relevant provisions of the *AIFMD level 2 regulation* to be inserted which

supplements the meaning of financial instruments that can be held in custody]

Depository functions: safekeeping of other assets

- 3.11.20 R In relation to assets of the *AIF* that are not *AIF custodial assets*, a *depository* must:
- (1) verify that the *AIF*, or the *AIFM* acting on behalf of the *AIF*, is the owner of the assets based on information or documents provided by the *AIF* or the *AIFM* and, where available, on external evidence; and
 - (2) maintain and keep up to date a record of those assets for which it is satisfied that the *AIF*, or the *AIFM* acting on behalf of the *AIF*, is the owner.

[**Note:** article 21(8)(b) of *AIFMD*]

Reuse of assets

- 3.11.21 R A *depository* must not reuse the assets of the *AIF* without the prior consent of the *AIF* or the *AIFM* acting on behalf of the *AIF*.

[**Note:** article 21(10) third paragraph of *AIFMD*]

Depository functions: oversight

- 3.11.22 R A *depository* must:
- (1) ensure that the sale, issue, repurchase, redemption and cancellation of *units* or *shares* of the *AIF* are carried out in accordance with the applicable national law and the *instrument constituting the fund*;
 - (2) ensure that the value of the *units* or *shares* of the *AIF* is calculated in accordance with the applicable national law, the *instrument constituting the fund* and *FUND* 3.9 (Valuation);
 - (3) carry out the instructions of the *AIFM*, unless they conflict with the applicable national law or the *instrument constituting the fund*;
 - (4) ensure that in transactions involving the *AIF*'s assets, any consideration is remitted to the *AIF* within the usual time limits; and
 - (5) ensure that an *AIF*'s income is applied in accordance with the applicable national law and the *instrument constituting the fund*.

[**Note:** article 21(9) of *AIFMD*]

Delegation: general prohibition

- 3.11.23 R A *depository* must not delegate its functions to third parties, except as permitted by *FUND* 3.11.25R.

[**Note:** article 21(11) first paragraph of *AIFMD*]

- 3.11.24 G The use of the services provided by securities settlement systems, as specified in the *Settlement Finality Directive*, or the use of similar services provided by third-country securities settlement systems, does not constitute a delegation by the *depository* of its functions.

[**Note:** article 21(11) fifth paragraph of *AIFMD*]

Delegation: safekeeping

- 3.11.25 R A *depository* may delegate the functions in *FUND* 3.11.18R and *FUND* 3.11.20R to third parties, subject to the following conditions:
- (1) the tasks are not delegated with the intention of avoiding the requirements of *AIFMD*;
 - (2) the *depository* can demonstrate that there is an objective reason for the delegation;
 - (3) the *depository*:
 - (a) has exercised all due skill, care and diligence in the selection and the appointment of any third party to whom it wants to delegate parts of its tasks; and
 - (b) continues to exercise all due skill, care and diligence in the periodic review and ongoing monitoring:
 - (i) of any third party to whom it has delegated parts of its tasks; and
 - (ii) of the arrangements of that third party in respect of the matters delegated to it; and
 - (4) the *depository* ensures that the third party delegate meets the following conditions at all times:
 - (a) the third party has structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the *AIF*, or the *AIFM* acting on behalf of the *AIF*, that have been entrusted to it;
 - (b) (subject to *FUND* 3.11.26R) for custody tasks in relation to *AIF custodial assets*, the third party is subject to:
 - (i) effective prudential regulation, including minimum capital requirements, and supervision in the jurisdiction concerned; and
 - (ii) an external periodic audit to ensure that the *financial*

instruments remain in its custody;

- (c) the third party segregates the assets of the *depository's* clients from its own assets and from the assets of the *depository* in such a way that they can at any time be clearly identified as belonging to clients of a particular *depository*;
- (d) the third party does not make use of the assets unless it has:
 - (i) obtained the prior consent of the *AIF*, or the *AIFM* acting on behalf of the *AIF*; and
 - (ii) given prior notification to the *depository*; and
- (e) the third party complies with the general obligations and prohibitions relating to the *depository* in *FUND* 3.11.4R, *FUND* 3.11.8R, *FUND* 3.11.18R, *FUND* 3.11.20R and *FUND* 3.11.21R.

[**Note:** article 21(11) second paragraph of *AIFMD*]

Delegation: third countries

- 3.11.26 R A *depository* may delegate custody tasks in relation to *AIF custodial assets* to an entity in a third country that does not satisfy the conditions in *FUND* 3.11.25R(4)(b), provided that:
- (1) the law of that third country requires certain *AIF custodial assets* to be held in custody by a local entity;
 - (2) no local entity satisfies the conditions in *FUND* 3.11.25R(4)(b);
 - (3) the *depository* delegates its functions to such a local entity only to the extent required by the law of that third country and only for as long as there is no local entity that satisfies the delegation conditions in *FUND* 3.11.25R(4)(b);
 - (4) the investors of the relevant *AIF* are informed before their investment that such delegation is required due to legal constraints in the third country and of the reasons as to why the delegation is necessary; and
 - (5) the *AIF*, or the *AIFM* on behalf of the *AIF*, has consented to the delegation arrangements before they become effective.

[**Note:** article 21(11) third paragraph of *AIFMD*]

Delegation: sub-delegation

- 3.11.27 R A *depository* must ensure that a third party to whom the *depository* has delegated functions does not, in turn, sub-delegate those functions delegated to it unless the delegate complies with the same requirements that apply to

the *depository*, with any necessary changes, in relation to:

- (1) the delegation by the *depository* of its functions in *FUND 3.11.23R* to *FUND 3.11.26R*; and
- (2) the discharge by the *depository* of its liability in regulation [x] of the *AIFMD UK regulation*.

[**Note:** article 21(11) fourth paragraph of *AIFMD*]

Delegation: omnibus account

- 3.11.28 G A *depository* may delegate the safe-keeping of assets to a third party that maintains a common account for multiple *AIFs*, a so-called ‘omnibus account’, provided it is a segregated common account.

[**Note:** recital 40 of *AIFMD*]

Provision of information

- 3.11.29 G The requirements of *SUP 2* (Information gathering by the *FCA* on its own initiative) apply to the *depository*, under which it must enable the *FCA* to obtain, on request, all information that the *depository* has obtained while discharging its duties and that the *FCA* considers necessary.

[**Note:** article 21(16) of *AIFMD*]

AIFM of a non-EEA AIF

- 3.11.30 R An *AIFM* of a *non-EEA AIF* which is *marketed* in the *United Kingdom* must:
- (1) ensure that the duties referred to in *FUND 3.11.17R*, *FUND 3.11.18R*, *FUND 3.11.20R* and *FUND 3.11.22R* are carried out in relation to that *AIF*:
 - (a) by a single *depository* which meets the criteria set out in *FUND 3.11.9R*, or where applicable *FUND 3.11.11R*, where any of the duties are carried out in the *United Kingdom*; or
 - (b) by one or more entities which are not *established* in the *United Kingdom*;
 - (2) not perform the duties referred to in (1) itself; and
 - (3) provide the *FCA* with information about the identity of those entities responsible for carrying out the duties referred to in (1).

[**Note:** article 36(1)(a) of *AIFMD*]

Subordinate measures

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules

supplementing this section]

4. Common requirements for all retail funds

[To follow]

5. Additional requirements for retail alternative investment funds

[To follow]

6. Additional requirements for qualified investor alternative investment funds

[To follow]

7. Additional requirements for UCITS funds

[To follow]

8. Additional requirements for UCITS and AIF master-feeder arrangements

[To follow]

9. Suspension of dealings and termination of authorised funds

[To follow]

10. Operating on a cross-border basis

[To follow]

11. Recognised funds

[To follow]

Appendices

[To follow]

Transitional Provisions and Schedules

[To follow]

Annex B

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

<i>acting as a depositary of an AIF</i>	the <i>regulated activity</i> , specified in [article xx] of the <i>Regulated Activities Order</i> of acting as a <i>depositary</i> etc. of an <i>AIF</i> .
<i>acting as a depositary of a UCITS</i>	the <i>regulated activity</i> , specified in [article xx] of the <i>Regulated Activities Order</i> of acting as a <i>depositary</i> etc of a <i>UCITS</i> .
<i>AIF</i>	<i>alternative investment fund</i> .
<i>AIF custodial assets</i>	<i>financial instruments</i> of an <i>AIF</i> that that can be: (a) registered in a <i>financial instruments</i> account opened in the <i>depositary</i>'s books; or (b) physically delivered to the <i>depositary</i>.
<i>AIFM</i>	<i>alternative investment fund manager</i> .
<i>AIFM investment firm</i>	a <i>firm</i> which: (a) is: (i) a <i>full scope UK AIFM</i>; or (ii) an <i>incoming EEA AIFM branch</i>; and (b) has a <i>Part IV permission</i> (or an equivalent permission from its <i>Home State regulator</i>) for <i>managing investments</i> where: (i) the <i>investments</i> managed include one or more <i>financial instruments</i>; and (ii) the <i>permission</i> is limited to the activities permitted by article 6(4) of <i>AIFMD</i> as well as those permitted by article 6(2).
<i>AIFM investment management functions</i>	investment management functions of an <i>AIFM</i> referred to in point 1(a) (portfolio management) or (b) (risk management) of Annex I to <i>AIFMD</i> .

<i>AIFM management functions</i>	the management functions of an <i>AIFM</i> listed in Annex I to <i>AIFMD</i> .
<i>AIFM Remuneration Code</i>	as set out in SYSC 19B (<i>AIFM Remuneration Code</i>).
<i>AIFM Remuneration Code staff</i>	(for an <i>AIFM</i>) has the meaning given in SYSC 19B.1.3R.
<i>AIFM Remuneration principles</i>	the principles set out in SYSC 19B.1.5R to SYSC 19B.1.24R.
<i>AIFMD</i>	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.
<i>AIFMD level 2 regulation</i>	Commission delegated regulation (EU) No ../.. supplementing Directive 2011/16/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.
<i>AIFMD UK regulation</i>	the Alternative Investment Fund Managers Regulations 2013 (SI 2013/....)
<i>alternative investment fund</i>	(in accordance with article 4(1)(a) of <i>AIFMD</i>) a collective investment undertaking, including investment compartments thereof, which: (a) raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (b) does not require authorisation pursuant to article 5 of the <i>UCITS Directive</i>.
<i>alternative investment fund manager</i>	(in accordance with article 4(1)(b) of <i>AIFMD</i>) a legal person whose regular business is performing <i>AIFM investment management functions</i> for one or more <i>AIF</i> .
<i>authorised AIF</i>	an <i>AIF</i> which is an <i>authorised fund</i> .
<i>carried interest</i>	a share in the profits of the <i>AIF</i> accrued to the <i>AIFM</i> as compensation for the management of the <i>AIF</i> , and excluding any share in the profits of the <i>AIF</i> accrued to the <i>AIFM</i> as a return on any investment by the <i>AIFM</i> into the <i>AIF</i> .
<i>collective portfolio management investment firm</i>	a <i>firm</i> which has a <i>Part IV permission</i> for managing investments and which is:

	(a) an <i>AIFM investment firm</i>; or (b) a <i>UCITS investment firm</i>.
<i>collective portfolio management firm</i>	a <i>firm</i> which: (a) (i) is a <i>full scope UK AIFM</i> (other than an <i>internally managed AIF</i>); and (ii) does not have a <i>Part IV permission</i> to carry on any <i>regulated activities</i> other than those which are in connection with, or for the purpose of, the <i>AIF</i> it manages; or (b) is a <i>UCITS firm</i> that has a <i>Part IV permission</i> for <i>managing a UCITS</i>.
<i>EEA AIF</i>	an <i>AIF</i>, other than a <i>UK AIF</i>, which: (a) is authorised or registered in an <i>EEA State</i> under the applicable national law; or (b) an <i>AIF</i> which is not authorised or registered in an <i>EEA State</i> but has its registered office or head office in an <i>EEA state</i>.
<i>EEA AIFM</i>	an <i>AIFM</i> which has its registered office in an <i>EEA State</i> other than the <i>United Kingdom</i> .
<i>established</i>	(in accordance with article 4(1)(j) <i>AIFMD</i>): (a) for <i>AIFMs</i>, ‘having its registered office in’; (b) for <i>AIFs</i>, ‘being authorised or registered in’, or, if the <i>AIF</i> is not authorised or registered, ‘having its registered office in’; (c) for <i>depositories</i>, ‘having its registered office or branch in’.
<i>feeder AIF</i>	an <i>AIF</i> which: (a) invests at least 85 % of its assets in <i>units</i> or <i>shares</i> of another <i>AIF</i> or otherwise has an exposure of at least 85% of its assets to such an <i>AIF</i>; or (b) invests at least 85 % of its assets in two or more <i>AIFs</i> where those <i>AIFs</i> have identical investment strategies or otherwise has an exposure of at least 85% of its assets to such <i>AIFs</i>.

<i>full scope UK AIFM</i>	a <i>UK AIFM</i> which: (a) does not meet the conditions in regulation [x] of the <i>AIFMD UK Regulation</i>; or (b) meets the conditions in regulation [x] of the <i>AIFMD UK Regulation</i> but has opted in to <i>AIFMD</i> in accordance with article 3(4) of <i>AIFMD</i>.
<i>fund</i>	an <i>AIF</i> or a <i>collective investment scheme</i> .
<i>funds under management requirement</i>	(1) (in <i>IPRU(INV)</i> 7) an amount of <i>own funds</i> that a <i>collective portfolio management firm</i> and an <i>internally managed AIF</i> must hold as set out in <i>IPRU(INV)</i> 7.3.2R (Funds under management requirement). (2) (in <i>GENPRU</i>) an amount of <i>own funds</i> that a <i>collective portfolio management investment firm</i> must hold as set out in <i>GENPRU</i> 2.1.66R (Requirements for collective portfolio management investment firms).
<i>incoming EEA AIFM branch</i>	an <i>incoming EEA firm</i> which is an <i>AIFM</i> and exercising its right to establish a <i>branch</i> under <i>AIFMD</i> .
<i>internally managed AIF</i>	a <i>full scope UK AIFM</i> where the legal form of the <i>UK AIF</i> permits internal management and where the <i>AIF</i> 's governing body chooses not to appoint an external <i>AIFM</i> .
<i>leverage</i>	(in accordance with article 4(1)(v) of <i>AIFMD</i>) any method by which an <i>AIFM</i> increases the exposure of an <i>AIF</i> it manages whether through borrowing of cash or <i>securities</i> , or leverage embedded in <i>derivative</i> positions or by any other means.
<i>managing an AIF</i>	the <i>regulated activity</i> , specified in article [x] of the <i>Regulated Activities Order</i> of managing an <i>AIF</i> .
<i>managing a UCITS</i>	the <i>regulated activity</i> , specified in article [x] of the <i>Regulated Activities Order</i> of managing a <i>UCITS</i> .
<i>marketing</i>	a direct or indirect offering or placement at the initiative of the <i>AIFM</i> or on behalf of the <i>AIFM</i> of <i>units</i> or <i>shares</i> of an <i>AIF</i> it manages to or with investors domiciled or with a registered office in the <i>EEA</i> .
<i>master AIF</i>	an <i>AIF</i> in which a <i>feeder AIF</i> invests or to which a <i>feeder AIF</i> has an exposure, and which in either case is not itself a <i>feeder AIF</i> .
<i>non-EEA AIF</i>	an <i>AIF</i> which is not a <i>UK AIF</i> or an <i>EEA AIF</i> .
<i>non-EEA AIFM</i>	an <i>AIFM</i> which is not a <i>UK AIFM</i> or an <i>EEA AIFM</i> .

<i>non-listed company</i>	a <i>company</i> which has its registered office in the <i>EEA</i> and the <i>shares</i> of which are not <i>admitted to trading</i> on a <i>regulated market</i> .
<i>PE AIF depositary</i>	a <i>depositary</i> of an <i>AIF</i> appointed in accordance with the provisions of <i>FUND</i> 3.11.10R (PE AIF depositaries).
<i>PII capital requirement</i>	(1) (in <i>IPRU(INV)</i> 7) an amount of <i>own funds</i> that a <i>collective portfolio management firm</i> and an <i>internally managed AIF</i> must hold in relation to their professional indemnity insurance policy to cover any defined excess (as set out in article [x] of the <i>AIFMD level 2 regulation</i> (professional indemnity insurance) (as replicated in <i>IPRU(INV)</i> 7.3.16EU)) and exclusions to that policy (as set out in <i>IPRU(INV)</i> 7.3.17R (Professional negligence)). (2) (in <i>GENPRU</i>) an amount of <i>own funds</i> that a <i>collective portfolio management investment firm</i> must hold in relation to their professional indemnity insurance policy to cover any defined excess (as set out in article [x] of the <i>AIFMD level 2 regulation</i> (professional indemnity insurance) (as replicated in <i>GENPRU</i> 2.1.71EU)) and exclusions to that policy (as set out in <i>GENPRU</i> 2.1.72R (Requirements for collective portfolio management investment firms)).
<i>professional negligence capital requirement</i>	(1) (in <i>IPRU(INV)</i> 7) an amount of <i>own funds</i> that a <i>collective portfolio management firm</i> and an <i>internally managed AIF</i> must hold in relation to professional liability risks as set out in article [x] of the <i>AIFMD level 2 regulation</i> (additional own funds) (as replicated in <i>IPRU(INV)</i> 7.3.15EU) (Professional negligence). (2) (in <i>GENPRU</i>) an amount of <i>own funds</i> that a <i>collective portfolio management investment firm</i> must hold in relation to professional liability risks as set out in article [x] of the <i>AIFMD level 2 regulation</i> (additional own funds) (as replicated in <i>GENPRU</i> 2.1.70EU (Requirements for collective portfolio management investment firms)).
<i>Settlement Finality Directive</i>	Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.
<i>unauthorised AIF</i>	an <i>AIF</i> which is not an <i>authorised fund</i> .
<i>UK AIF</i>	an <i>AIF</i> that is;

- (a) an *authorised fund*; or
- (b) is not an *authorised fund* but has its registered office or head office in the *United Kingdom*.

UK AIFM

an AIFM that is *established* in the *United Kingdom* and has a *Part IV permission* to carry on the *regulated activity* of *managing an AIF*.

Amend the following existing definitions as shown.

base capital resources requirement

- (1) (in BIPRU) an amount of *capital resources* that an *insurer* must hold as set out in *GENPRU 2.1.30R* (Table: Base capital resources requirement for an insurer) or a *BIPRU firm* must hold under *GENPRU 2.1.41R* (Base capital resources requirement for a BIPRU firm) and *GENPRU 2.1.48R* (Table: Base capital resources requirement for a BIPRU firm) or, as the case may be, *GENPRU 2.1.60R* (Calculation of the base capital resources requirement for banks authorised before 1993).
- (2) (in IPRU(INV)) an amount of *own funds* that a *collective portfolio management firm* and an *internally managed AIF* must hold in accordance with *IPRU(INV) 7.3.1R* (Base capital resources requirement).

BIPRU 125k firm

has the meaning in *BIPRU 1.1.19R* (Types of investment firm: BIPRU 125K firm) which in summary is a *BIPRU investment firm* that satisfies the following conditions:

...

- (4) it is not a ~~*UCITS investment firm*~~ *collective portfolio management investment firm*; and

...

BIPRU 50k firm

has the meaning in *BIPRU 1.1.20R* (Types of investment firm: BIPRU 50K firm) which in summary is a *BIPRU investment firm* that satisfies the following conditions:

...

- (c) it is not a ~~*UCITS investment firm*~~ *collective portfolio management investment firm*; and

...

<i>BIPRU 730k firm</i>	has the meaning in <i>BIPRU</i> 1.1.21R (Types of investment firm: <i>BIPRU</i> 730K firm) which in summary is a <i>BIPRU investment firm</i> that is not a <i>UCITS investment firm</i> <u><i>collective portfolio management investment firm</i></u> , a <i>BIPRU</i> 50K firm or a <i>BIPRU</i> 125K firm.
<i>BIPRU investment firm</i>	has the meaning set out <i>BIPRU</i> 1.1.8R (Definition of a <i>BIPRU</i> investment firm), which is in summary one of the following types of <i>BIPRU firm</i> : ... including a <i>UCITS investment firm</i> <u><i>collective portfolio management investment firm</i></u> that is not excluded under <i>BIPRU</i> 1.1.7R (Exclusion of certain types of <i>firm</i> from the definition of <i>BIPRU firm</i>).
<i>branch</i>	... (i) <u>(in relation to an <i>AIFM</i>)</u> (a) <u>a place of business which is a part of an <i>AIFM</i>, which has no legal personality and which provides the services for which the <i>AIFM</i> has been authorised;</u> (b) <u>for the purpose of (a) all the places of business established in the same <i>EEA State</i> by an <i>AIFM</i> with its registered office in another <i>EEA State</i> shall be regarded as a single branch.</u> <u>[Note: article 4(1)(c) of <i>AIFMD</i>]</u>
<i>client money</i>	... (2A) (in <i>CASS</i> 6, <i>CASS</i> 7, <i>CASS</i> 7A and <i>CASS</i> 10 and, in so far as it relates to matters covered by <i>CASS</i> 6, <i>CASS</i> 7, or <i>COBS</i> , <i>GENPRU</i> or <i>IPRU(INV)</i> 7) subject to the <i>client money rules</i> , money of any currency: ...
<i>close links</i>	(1) (in relation to <i>MiFID business</i> or in <i>FUND</i>) a situation in which two or more persons are linked by: (a) participation which means the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking; (b) control which means the relationship between a parent undertaking and a subsidiary, in all the

cases referred to in Article 1(1) and (2) of Directive 83/349/EEC, or a similar relationship between any person and an undertaking, any subsidiary undertaking of a subsidiary undertaking also being considered a subsidiary of the parent undertaking which is at the head of those undertakings.

~~[Note: article 4(1)(31) of *MiFID*]~~

A situation in which two or more persons are permanently linked to one and the same person by a control relationship is also to be regarded as constituting a close link between such persons.

[Note: article 4(1)(31) of *MIFID* and article 4(1)(e) of *AIFMD*]

...

collateral

- (1) (in ~~*COLL FUND*~~) any form of security, guarantee or indemnity provided by way of security for the discharge of any liability arising from a transaction.

...

competent authority

...

- (8) (in relation to an *AIF* for the purposes of *FUND*) the national authorities of an *EEA State* which are empowered by law or regulation to supervise *AIFs*.

counterparty risk

(in ~~*COLL FUND*~~ and in accordance with article 3(7) of the ~~*UCITS implementing Directive*~~) the risk of loss for a *UCITS* or *AIF* resulting from the fact that the counterparty to a transaction may default on its obligations prior to the settlement of the transaction's cash flow.

depository

- (1) ...

- (c) (in relation to any other *unit trust scheme* other than an *AIF*) the *person* holding the property of the *scheme* on trust for the *participants*;

...

- (d) (in relation to any other *collective investment scheme* other than an *AIF*) any *person* to whom the property subject to the *scheme* is entrusted for safekeeping;

	(e) <u>(in relation to an AIF other than an ICVC or an AUT) the person fulfilling the function of a depositary in accordance with article 21(1) of AIFMD or, in respect of a non-EEA AIF, in accordance with FUND 3.11.30R(1)(a) (AIFM of a non-EEA AIF).</u>
	...
EEA firm	(in accordance with paragraph 5 of Schedule 3 to the Act (EEA Passport Rights)) any of the following, if it does not have its relevant office in the <i>United Kingdom</i> : ...
	(hh) <u>an AIFM which is authorised (within the meaning of article 8 of AIFMD) by its Home State regulator;</u> in this definition, relevant office means: ...
fixed overheads requirement	(1) <u>(in GENPRU) the part of the capital resources requirement calculated in accordance with GENPRU 2.1.53 R(Calculation of the fixed overheads requirement).</u> (2) <u>(in IPRU(INV) 7) the part of the own funds requirement calculated in accordance with IPRU(INV) 7.3.4R (Fixed overheads requirement).</u>
funds under management	(in UPRU IPRU(INV) and GENPRU) <u>funds managed by the firm, including funds where it has delegated the management function but excluding funds that it is managing as delegate.</u> (1) collective investment schemes other than OEICs managed by the firm including schemes where it has delegated the management function but excluding schemes that it is managing as delegate; and (2) OEICs for which the firm is the designated management company.
Home State	... (13) <u>(in relation to an AIF) the EEA State in which:</u> (a) <u>the AIF is authorised or registered under applicable national law; or</u> (b) <u>if the AIF is neither authorised nor registered in an EEA State, the EEA State in which the AIF</u>

has its registered office and/or head office.

[Note: article 4(1)(p) of AIFMD]

- (14) (in relation to an AIFM) the EEA State in which the AIFM has its registered office.

[Note: article 4(1)(q) of AIFMD]

initial capital

...

- (3) (in ~~UPRU~~ IPRU(INV) 7) capital calculated in accordance with ~~UPRU~~ IPRU(INV) Table 2.2.1R 7.4 (Method of calculating initial capital and own funds) composed of the specified items set out in that Table.

instrument constituting the scheme fund

...

- (bb) (in relation to an AIF other than an ICVC or an AUT) the fund rules, instrument of incorporation or other constituting documents of such an AIF;

...

issuer

- (1) (except in ~~LR, PR and DTR~~ as otherwise provided for below):

...

- (6) (in FUND) means an issuer within the meaning of article 2(1)(d) of the Transparency Directive where that issuer has its registered office in the EEA and where its shares are admitted to trading on a regulated market.

liquidity risk

- (1) (in ~~COLL~~ in relation to a UCITS and in accordance with article 3(8) of the UCITS implementing Directive) the risk that a position in a UCITS' portfolio cannot be sold, liquidated or closed out at limited cost in an adequately short timeframe and that the ability of the scheme to comply at any time with COLL 6.2.16R (Sale and redemption) or, in the case of an EEA UCITS scheme, article 84(1) of the UCITS Directive is thereby compromised.
- (2) (except in ~~COLL~~ relation to a UCITS) the risk that a firm, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due, or can secure such

	resources only at excessive cost.
market risk	(1) (in <i>COLL FUND</i> and in accordance with article 3(9) of the <i>UCITS implementing Directive</i>) the risk of loss of a <i>UCITS</i> or <i>AIF</i> resulting from fluctuation in the market value of positions in the <i>scheme's fund's</i> portfolio attributable to changes in market variables, such as interest rates, foreign exchange rates, equity and commodity prices or an issuer's credit worthiness. (2) (except in <i>COLL FUND</i>) (in relation to a <i>firm</i>) the risks that arise from fluctuations in values of, or income from, assets or in interest or exchange rates.
MiFID investment firm	(in summary) a <i>firm</i> to which <i>MiFID</i> applies including, for some purposes only, a <i>credit institution</i> and <i>UCITS investment firm collective portfolio management investment firm</i>. (in full) a <i>firm</i> which is: ... (3) a <i>UCITS investment firm collective portfolio management investment firm</i> (only when providing the services referred to in article 6(4) <i>AIFMD</i> or Article 6(3) of the <i>UCITS Directive</i> in relation to the rules implementing the articles of <i>MiFID</i> referred to in article 6(6) of <i>AIFMD</i> or Article 6(4) of that Directive the <i>UCITS Directive</i> (as appropriate)); unless, and to the extent that, <i>MiFID</i> does not apply to it as a result of Article 2 (Exemptions) or Article 3 (Optional exemptions) of <i>MiFID</i>.
operational risk	(1) (in <i>COLL FUND</i> and in accordance with article 3(10) of the <i>UCITS implementing Directive</i>) the risk of loss for a <i>UCITS</i> or <i>AIF</i> resulting from inadequate internal processes and failures in relation to the people and systems of the <i>management company or AIFM</i> or from external events, and it includes legal and documentation risk and risk resulting from the trading, settlement and valuation procedures operated on behalf of the <i>scheme fund</i>. (2) (except in <i>COLL FUND</i>) (in accordance with Article 4(22) of the <i>Banking Consolidation Directive</i>) the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.
own funds	...

	(2A) <u>(in IPRU(INV) 7) the own funds of a firm calculated in accordance with IPRU(INV) Table 7.4 (Method of calculating initial capital and own funds).</u>
	...
<i>prime brokerage firm</i>	(1) <u>(except in FUND) a firm that provides prime brokerage services to a client and which may do so acting as principal.</u> (2) <u>(in FUND) a credit institution, investment firm or another firm, offering services to professional clients primarily to finance or execute transactions in financial instruments as counterparty and which may also provide other services, such as clearing and settlement of trades, custodial services, stock lending, customised technology and operational support facilities.</u> <u>[Note: article 4(1)(af) of AIFMD]</u>
<i>prospectus</i>	(1) <u>(in LR, PR, and FEES and FUND 3 (Requirements for managers of alternative investment funds)) a prospectus required under the prospectus directive.</u>
	...
<i>qualifying capital instrument</i>	<u>(in UPRU IPRU(INV)) means that part of a firm's capital which is a security of indeterminate duration, or other instrument, that fulfils the following conditions:</u>
	...
<i>qualifying capital item</i>	<u>(in UPRU IPRU(INV)) means that part of a firm's capital which has the following characteristics:</u>
	...
<i>qualifying subordinated loan</i>	<u>(in UPRU IPRU(INV) 7) has the meaning given in IPRU(INV) 5.2.5(1) to (7) 7.5 (Qualifying subordinated loans).</u>
<i>readily realisable investment</i>	(1) <u>(except in UPRU IPRU(INV))</u> (a) a packaged product; (b) a readily realisable security. (2) <u>(in UPRU IPRU(INV)) means a unit in a regulated collective investment scheme, a life policy or any marketable investment other than one which is traded on or under the rules of a recognised or designated</u>

investment exchange so irregularly or infrequently:

(a) ...

Single Market Directive

...

(d) the *Insurance Mediation Directive*; ~~and~~

(e) the *UCITS Directive*; and

(f) AIFMD.

trading book

(1) ...

(2) (in *BIPRU*, *GENPRU* ~~and~~, *BSOCS* and *IPRU(INV)* 7 and in relation to a *BIPRU firm*) has the meaning in *BIPRU* 1.2 (Definition of the trading book) which is in summary, all that *firm's positions* in *CRD financial instruments* and *commodities* held either with trading intent or in order to hedge other elements of the *trading book*, and which are either free of any restrictive covenants on their tradability or able to be hedged.

(3) ...

unit

(1) (in relation to a collective investment scheme) the investment, specified in article 81 of the *Regulated Activities Order* (Units in a collective investment scheme) and defined in section 237(2) of the *Act* (Other definitions)), which is the right or interest (however described) of the *participants* in a *collective investment scheme*; this includes:

(a) (in relation to an *AUT*) a unit representing the rights or interests of the *unitholders* in the *AUT*; and

(b) (in relation to an *ICVC*) a *share* in the *ICVC*; and

(2) (in relation to an alternative investment fund) the right or interest (however described) of an investor in an alternative investment fund.

Annex C

Amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC)

In this Annex, underlining indicates new text and striking through indicates deleted text except where indicated otherwise.

4.1 General requirements

4.1.1 R ...

- (3) A full scope UK AIFM must comply with the AIFM Remuneration Code.

[**Note:** article 22(1) of the *Banking Consolidation Directive*, article 13(5) second paragraph of *MiFID* ~~and~~, article 12(1)(a) of the *UCITS Directive*, and article 13(1) of AIFMD]

4.1.1A R A full scope UK AIFM must in particular:

- (1) have rules for personal transactions by its employees or for the holding or management of investments it invests on its own account;
- (2) ensure that each transaction involving the AIFs may be reconstructed according to its origin, the parties to it, its nature, and the time and place at which it was effected; and
- (3) ensure that the assets of the AIFs managed by the AIFM are invested in accordance with the instrument constituting the fund and the legal provisions in force.

[**Note:** article 18(1) second paragraph of *AIFMD*]

4.1.2 R For a *common platform firm*, the arrangements, processes and mechanisms referred to in SYSC 4.1.1R must be comprehensive and proportionate to the nature, scale and complexity of the *common platform firm's* activities and must take into account the specific technical criteria described in SYSC 4.1.7R, SYSC 5.1.7R, SYSC 7 and (for a *BIPRU firm* and a *third country BIPRU firm*) SYSC 19A or (for a full scope UK AIFM) SYSC 19B.

...

4.1.2B R For a *management company* or a full scope UK AIFM, the arrangements, processes and mechanisms referred to in SYSC 4.1.1R and SYSC 4.1.1AR must also take account of the *UCITS schemes* and *EEA UCITS schemes* managed by the *management company* or the AIFs managed by the full scope UK AIFM.

[**Note:** article 12(1) second paragraph of the *UCITS Directive* and article 18(1) second paragraph of AIFMD]

Resources for management companies and AIFMs

- 4.1.2C R *A management company, a full scope UK AIFM and an incoming EEA AIFM branch* must have, and employ effectively, the resources and procedures that are necessary for the proper performance of its business activities.

[**Note:** articles 12(1)(a) and 14(1)(c) of the *UCITS Directive* and article 12(1)(c) of AIFMD]

- 4.1.2D R A full scope UK AIFM must use, at all times, adequate and appropriate human and technical resources that are necessary for the proper management of AIFs.

[**Note:** article 18(1) first paragraph of *AIFMD*]

Subordinate measures relating to provisions implementing article 12(1) of AIFMD

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing the provisions of article 12(1) of *AIFMD*]

...

- 4.2.1 R The senior personnel of a common platform firm, a management company, a full scope UK AIFM, or the UK branch of a non-EEA bank must be of sufficiently good reputation and sufficiently experienced as to ensure the sound and prudent management of the firm.

[**Note:** article 9(1) of *MiFID*, article 7(1)(b) of the *UCITS Directive*, article 8(1)(c) of AIFMD, and article 11(1) second paragraph of the *Banking Consolidation Directive*]

...

- 4.2.2 R A common platform firm, a management company, a full scope UK AIFM and the UK branch of a non-EEA bank must ensure that its management is undertaken by at least two persons meeting the requirements laid down in SYSC 4.2.1R and, in the case of a full scope UK AIFM, SYSC 4.2.7R.

[**Note:** article 9(4) first paragraph of *MiFID*, article 7(1)(b) of the *UCITS Directive*, article 8(1)(c) of AIFMD and article 11(1) first paragraph of the *Banking Consolidation Directive*]

...

- 4.2.4 G At least two independent minds should be applied to both the formulation and implementation of the policies of a common platform firm, a management company, a full scope UK AIFM and the UK branch of a non-EEA bank. Where such a firm nominates just two individuals to direct its business, the *FSA FCA* will not regard them as both effectively directing the business

where one of them makes some, albeit significant, decisions relating to only a few aspects of the business. Each should play a part in the decision-making process on all significant decisions. Both should demonstrate the qualities and application to influence strategy, day-to-day policy and its implementation. This does not require their day-to-day involvement in the execution and implementation of policy. It does, however, require involvement in strategy and general direction, as well as knowledge of, and influence on, the way in which strategy is being implemented through day-to-day policy.

- 4.2.5 G Where there are more than two individuals directing the business of a *common platform firm*, a *management company*, a full scope UK AIFM or the UK branch of a *non-EEA bank*, the ~~FSA~~ FCA does not regard it as necessary for all of these individuals to be involved in all decisions relating to the determination of strategy and general direction. However, at least two individuals should be involved in all such decisions. Both individuals' judgement should be engaged so that major errors leading to difficulties for the *firm* are less likely to occur. Similarly, each individual should have sufficient experience and knowledge of the business and the necessary personal qualities and skills to detect and resist any imprudence, dishonesty or other irregularities by the other individual. Where a single individual, whether a chief executive, managing *director* or otherwise, is particularly dominant in such a *firm* this will raise doubts about whether SYSC 4.2.2 R is met.

...

Responsibility of senior personnel of an AIFM

- 4.2.7 R In the case of a *full scope UK AIFM* the senior personnel must, in meeting the requirements in SYSC 4.2.1R, be sufficiently experienced in relation to the investment strategies pursued by the *AIFs* it manages.

[Note: article 8(1)(c) of *AIFMD*]

- 4.2.8 R A *full scope UK AIFM* must notify the *FCA* of the names of the senior personnel of the *firm* and of every person succeeding them in office.

[Note: article 8(1)(c) of *AIFMD*]

- 4.2.9 G Where the senior personnel of a *full scope UK AIFM* will carry out a governing function and the *firm* has applied for the *FCA*'s approval under section 59 of the *Act*, this will be considered sufficient to comply with SYSC 4.2.7R.

...

- 6.1.4-A G In setting the method of determining the remuneration of relevant persons involved in the compliance function, *BIPRU firms* and full scope UK AIFMs will also need to comply with the *Remuneration Code* or *AIFM Remuneration Code* (as applicable).

...

7.1.7B In setting the method of determining the *remuneration of employees* involved in the risk management function, *BIPRU firms and full scope UK AIFMs* will also need to comply with the *Remuneration Code or AIFM Remuneration Code* (as applicable).

...

10 Conflicts of interest

10.1 Application

- 10.1.1 R (1) This section applies to a *firm* which provides services to its *clients* in the course of carrying on *regulated activities* or *ancillary activities* or providing *ancillary services* (but only where the *ancillary services* constitute *MiFID business*).
- (2) This section also applies to a *management company*.
- (3) This section also applies to:
- (a) a full scope UK AIFM of:
- (i) a UK AIF;
- (ii) an EEA AIF managed or marketed from an establishment in the UK; and
- (iii) a non-EEA AIF; and
- (b) an incoming EEA AIFM branch which manages or markets a UK AIF.

...

Collective portfolio management investment firms

- 10.1.22 R A collective portfolio management investment firm which manages investments other than for an AIF or UCITS for which it has been appointed as manager, must obtain approval from its client before it invests all or part of the client's portfolio in units or shares of an AIF or UCITS it manages.

[**Note:** article 12(2)(a) of the *UCITS Directive* and article 12(2)(a) of *AIFMD*]

Additional requirements for an AIFM

- 10.1.23 R An AIFM must take all reasonable steps to identify conflicts of interest that arise, in the course of managing AIFs, between:
- (1) the AIFM, including its managers, employees or any person directly or indirectly linked to the AIFM by control, and an AIF managed by the AIFM or the investors in that AIF; or

- (2) an AIF or the investors in that AIF, and another AIF or the investors in that AIF; or
- (3) an AIF or the investors in that AIF, and another client of the AIFM; or
- (4) an AIF or the investors in that AIF, and a UCITS managed by the AIFM or the investors in that UCITS; or
- (5) two clients of the AIFM.

[Note: article 14(1) first paragraph of AIFMD]

- 10.1.24 **R** An AIFM must take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, manage, monitor and, where applicable, disclose those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs it manages are fairly treated.

[Note: article 12(1)d of AIFMD]

- 10.1.25 **R** An AIFM must:
- (1) maintain and operate effective organisational and administrative arrangements, with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors;
 - (2) segregate, within its own operating environment, tasks and responsibilities which may be regarded as incompatible with each other or which may potentially generate systematic conflicts of interest; and
 - (3) assess whether its operating conditions may involve any other material conflicts of interest and disclose them to the AIF's investors.

[Note: article 14(1) second and third paragraphs of AIFMD]

- 10.1.26 **R** If the organisational arrangements made by the AIFM to identify, prevent, manage and monitor conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to investors' interests will be prevented, the AIFM must:
- (1) clearly disclose the general nature or sources of conflicts of interest to the investors before undertaking business on their behalf; and
 - (2) develop appropriate policies and procedures.

[Note: article 14(2) of AIFMD]

Subordinate measures for alternative investment fund managers

[Note: articles [x] to [y] of the AIFMD level 2 regulation lay down detailed rules supplementing the provisions of article 14 of AIFMD]

...

19A Remuneration Code

19A.1 General application and purpose

Who? What? Where?

19A.1.1 ...

19A.1.1 G The AIFM Remuneration Code (SYSC 19B) also applies to a firm which is a full scope UK AIFM. A full scope UK AIFM that complies with all the provisions of SYSC 19B will also comply with all the provisions of SYSC 19A. In such cases, the FCA will not require the full scope UK AIFM to demonstrate compliance with SYSC 19A.

Insert the following section after SYSC 19A. The following text is all new and is not underlined.

19B AIFM Remuneration Code

19B.1 Application

19B.1.1 R The AIFM Remuneration Code applies to a full scope UK AIFM of:

- (1) a UK AIF;
- (2) an EEA AIF; and
- (3) a non-EEA AIF.

Remuneration policies and practices

19B.1.2 R An AIFM must establish, implement and maintain *remuneration* policies and practices for *AIFM Remuneration Code staff* that are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profile of the *instrument constituting the fund* of the AIFs it manages.

[Note: article 13(1) of AIFMD]

19B.1.3 R AIFM Remuneration Code staff comprise those categories of staff, including

senior management, risk takers, control functions, and any *employees* receiving total *remuneration* that takes them into the same *remuneration* bracket as senior management and risk takers whose professional activities have a material impact on the risk profiles of the *AIFMs* or of the *AIFs* the *AIFM* manages.

[**Note:** article 13(1) of *AIFMD*]

- 19B.1.4 R (1) When establishing and applying the total *remuneration* policies, inclusive of salaries and discretionary pension benefits, for *AIFM Remuneration Code staff*, an *AIFM* must comply with the *AIFM remuneration principles* in a way and to the extent that is appropriate to its size, internal organisation and the nature, scope and complexity of its activities.
- (2) Paragraph (1) does not apply to the requirement for significant *AIFMs* to have a *remuneration* committee (SYSC 19B.1.9R).
- (3) The *AIFM remuneration principles* apply to remuneration of any type paid by the *AIFM*, to any amount paid directly by the *AIF* itself, including *carried interest*, and to any transfer of *units* or *shares* of the *AIF*, made to the benefits of *AIFM Remuneration Code staff*.

[**Note:** paragraph 1 and 2 of Annex II of *AIFMD*]

Remuneration principles for *AIFMs*

AIFM Remuneration Principle 1: Risk management

- 19B.1.5 R An *AIFM* must ensure that its *remuneration* policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles of the *instrument constituting the fund* of the *AIFs* it manages.

[**Note:** paragraph 1(a) of Annex II of *AIFMD*]

AIFM Remuneration Principle 2: Supporting business strategy, objectives, values and interests, and avoiding conflicts of interest

- 19B.1.6 R An *AIFM* must ensure that its *remuneration* policy is in line with the business strategy, objectives, values and interests of the *AIFM* and the *AIFs* it manages or the investors of such *AIFs*, and includes measures to avoid conflicts of interest.

[**Note:** paragraph 1(b) of Annex II of *AIFMD*]

AIFM Remuneration Principle 3: Governance

- 19B.1.7 R An *AIFM* must ensure that the *governing body* of the *AIFM*, in its supervisory function, adopts and periodically reviews the general principles of the *remuneration* policy and is responsible for its implementation.

[**Note:** paragraph 1(c) of Annex II of *AIFMD*]

- 19B.1.8 R An *AIFM* must ensure the implementation of the *remuneration* policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for *remuneration* adopted by the *governing body* in its supervisory function.

[**Note:** paragraph 1(d) of Annex II of *AIFMD*]

- 19B.1.9 R
- (1) An *AIFM* that is significant in terms of its size, internal organisation and the nature, the scope and the complexity of its activities must establish a *remuneration* committee.
 - (2) The *remuneration* committee must be constituted in a way that enables it to exercise competent and independent judgment on *remuneration* policies and practices and the incentives created for managing risk.
 - (3) The chairman and the members of the *remuneration* committee must be members of the *governing body* who do not perform any executive function in the *AIFM*.
 - (4) The *remuneration* committee must be responsible for the preparation of decisions regarding *remuneration*, including those which have implications for the risk and risk management of the *AIFM* or the *AIF* concerned and which are to be taken by the *governing body* in its supervisory function.

[**Note:** paragraph 3 of Annex II of *AIFMD*]

AIFM Remuneration Principle 4: Control functions

- 19B.1.10 R An *AIFM* must ensure that *employees* engaged in control functions are compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control.

[**Note:** paragraph 1(e) of Annex II of *AIFMD*]

- 19B.1.11 R An *AIFM* must ensure the *remuneration* of the senior officers in the risk management and compliance functions is directly overseen by the *remuneration* committee, or, if such a committee has not been established, by the *governing body* in its supervisory function.

[**Note:** paragraph 1(f) of Annex II of *AIFMD*]

AIFM Remuneration Principle 5(a): Remuneration structures – assessment of performance

- 19B.1.12 R An *AIFM* must ensure that where *remuneration* is performance related, the total amount of *remuneration* is based on a combination of the assessment of

the performance of the individual and of the business unit or *AIF* concerned and of the overall results of the *AIFM*. When assessing individual performance, financial as well as non-financial criteria are taken into account.

[**Note:** paragraph 1(g) of Annex II of *AIFMD*]

- 19B.1.13 R An *AIFM* must ensure that the assessment of performance is set in a multi-year framework appropriate to the life-cycle of the *AIFs* managed by the *AIFM* in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the redemption policy of the *AIFs* it manages and their investment risks.

[**Note:** paragraph 1(h) of Annex II of *AIFMD*]

AIFM Remuneration Principle 5(b): Remuneration structures – guaranteed variable remuneration

- 19B.1.14 R An *AIFM* must not award, pay or provide guaranteed variable remuneration unless it;
- (1) is exceptional;
 - (2) occurs only in the context of hiring new staff; and
 - (3) is limited to the first year of service.

[**Note:** paragraph 1(i) of Annex II of *AIFMD*]

AIFM Remuneration Principle 5(c): Remuneration structures – ratios between fixed and variable components of total remuneration

- 19B.1.15 R An *AIFM* must set appropriate ratios between the fixed and variable components of total *remuneration* and ensure that:
- (1) fixed and variable components of total *remuneration* are appropriately balanced; and
 - (2) the fixed component represents a sufficiently high proportion of the total *remuneration* to allow the operation of a fully flexible policy on variable *remuneration* components, including the possibility to pay no variable *remuneration* component.

[**Note:** paragraph 1(j) of Annex II of *AIFMD*]

AIFM Remuneration Principle 5(d): Remuneration structures – payments related to early termination

- 19B.1.16 R An *AIFM* must ensure that payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure

[**Note:** paragraph 1(k) of Annex II of *AIFMD*]

AIFM Remuneration Principle 5(e): Remuneration structures – retained units, shares or other instruments

- 19B.1.17 R (1) Subject to the legal structure of the *AIF* and the *instrument constituting the fund*, an *AIFM* must ensure that a substantial portion, and in any event at least 50% of any variable *remuneration*, consists of *units* or *shares* of the *AIF* concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments, unless the management of *AIFs* accounts for less than 50% of the total portfolio managed by the *AIFM*, in which case the minimum of 50 % does not apply.
- (2) The instruments in (1) must be subject to an appropriate retention policy designed to align incentives with the long-term interests of the *AIFM* and the *AIFs* it manages and the investors of such *AIFs*.
- (3) This *rule* applies to both the portion of the variable *remuneration* component deferred in accordance with SYSC 19B.1.18R(1) and the portion not deferred.

[**Note:** paragraph 1(m) of Annex II of *AIFMD*]

AIFM Remuneration Principle 5(f): Remuneration structures – deferral

- 19B.1.18 R (1) An *AIFM* must not award, pay or provide a variable *remuneration* component unless a substantial portion, and in any event at least 40%, of the variable *remuneration* component, is deferred over a period which is appropriate in view of the life cycle and redemption policy of the *AIF* concerned and is correctly aligned with the nature of the risks of the *AIF* in question
- (2) The period referred to in (1) must be at least three to five years unless the life cycle of the *AIF* concerned is shorter.
- (3) *Remuneration* payable under (1) must vest no faster than on a pro-rata basis.
- (4) In the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount must be deferred.

[**Note:** paragraph 1(n) of Annex II of *AIFMD*]

AIFM Remuneration Principle 5(g): Remuneration structures – performance adjustment, etc.

- 19B.1.19 R An *AIFM* must ensure that any variable *remuneration*, including a deferred portion, is paid or vests only if it is sustainable according to the financial situation of the *AIFM* as a whole and justified according to the performance of the *AIF*, the business unit and the individual concerned.

[**Note:** paragraph 1(o) first sub-paragraph of Annex II of *AIFMD*]

- 19B.1.20 G The total variable *remuneration* should generally be considerably contracted where subdued or negative financial performance of the *AIFM* or of the *AIF* concerned occurs, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.

[**Note:** paragraph 1(o) second sub-paragraph of Annex II of *AIFMD*]

AIFM Remuneration Principle 6: Measurement of performance

- 19B.1.21 R An *AIFM* must ensure the measurement of performance used to calculate variable *remuneration* components, or pools of variable *remuneration* components, includes a comprehensive adjustment mechanism to integrate all relevant types of current and future risks.

[**Note:** paragraph 1(l) of Annex II of *AIFMD*]

AIFM Remuneration Principle 7: Pension policy

- 19B.1.22 R An *AIFM* must ensure that:
- (1) its pension policy is in line with its business strategy, objectives, values and long-term interests of the *AIFs* it manages;
 - (2) when an *employee* leaves the *firm* before retirement, any *discretionary pension benefits* are held by the *firm* for a period of five years in the form of instruments referred to in SYSC 19B.1.17 R(1); and
 - (3) in the case of an *employee* reaching retirement, *discretionary pension benefits* are paid to the *employee* in the form of instruments referred to in SYSC 19B.1.17R(1) and subject to a five-year retention period.

[**Note:** paragraph 1(p) of Annex II of *AIFMD*]

AIFM Remuneration Principle 8: Personal investment strategies

- 19B.1.23 R An *AIFM* must ensure that its *employees* undertake not to use personal hedging strategies or *remuneration*- and liability-related insurance to undermine the risk alignment effects embedded in their *remuneration* arrangements.

[**Note:** paragraph 1(q) of Annex II of *AIFMD*]

AIFM Remuneration Principle 9: Avoidance of the remuneration code

- 19B.1.24 R An *AIFM* must ensure that variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of the *AIFM Remuneration Code*.

[**Note:** paragraph 1(r) of Annex II of *AIFMD*]

Annex D

Amendments to the General Prudential sourcebook (GENPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

1.2 Adequacy of financial resources

...

- 1.2.11 G The adequacy of a *firm's* financial resources needs to be assessed in relation to all the activities of the *firm* and the risks to which they give rise and so this section applies to a *firm* in relation to the whole of its business. In the case of a ~~*UCITS investment firm*~~ *collective portfolio management investment firm* this means that this section is ~~not limited to designated investment business excluding scheme management activity~~. It also applies to ~~scheme management activity~~ and to activities that are not ~~designated investment business~~ its activities in relation to the management of AIFs and/or UCITS.

...

2.1 Calculation of capital resources requirement

...

- 2.1.8 G ...
- (3) In the case of a ~~*UCITS investment firm*~~ *collective portfolio management investment firm* this section implements article 9 of AIFMD and (in part) Article 7 of the *UCITS Directive*.

...

Calculation of the variable capital requirement for a BIPRU firm

2.1.45	R	<i>Firm category</i>	<i>Capital requirement</i>	
		...	...	
		<i>BIPRU limited licence firm (including UCITS investment firm collective portfolio management investment firm)</i>	the higher of (1) and (2):	
			(1)	The sum of:
			(a)	the <i>credit risk capital requirement</i> ; and
			(b)	the <i>market risk capital requirement</i> ; and

	(2)	the <i>fixed overheads requirement</i> .
--	-----	--

Adjustment of the variable capital requirement calculation for ~~UCITS investment firm~~ collective portfolio management investment firms

- 2.1.46 R When a ~~UCITS investment firm~~ collective portfolio management investment firm calculates the *credit risk capital requirement* and the *market risk capital requirement* for the purpose of calculating the variable capital requirement under GENPRU 2.1.40R it must do so only in respect of *designated investment business*. For this purpose ~~scheme management activity~~ managing an AIF or managing a UCITS is excluded from *designated investment business*.

...

Table: Base capital resources requirement for a BIPRU firm

2.1.48	R	<i>Firm category</i>	<i>Amount: Currency equivalent of</i>
		...	...
		UCITS investment firm <u>Collective portfolio management investment firm</u>	€125,000 plus, if the funds under management exceed €250,000,000, 0.02% of the excess, subject to a maximum of €10,000,000.

...

Requirements for collective portfolio management investment firms

- 2.1.63 R A collective portfolio management investment firm must maintain capital resources which equal or exceed the higher of (1) and (2).

(1) (a) The higher of:

- (i) the funds under management requirement (in accordance with GENPRU 2.1.66R); and
- (ii) the fixed overheads requirement (in accordance with GENPRU 2.1.53R); plus

(b) whichever is applicable of:

- (i) the professional negligence capital requirement (in accordance with GENPRU 2.1.67R(1)(a); or
- (ii) the PII capital requirement (in accordance with GENPRU 2.1.67R(1)(b).

(2) The amount specified in the table in GENPRU 2.1.45R.

- 2.1.64 R A collective portfolio management investment firm must hold liquid assets

(in accordance with GENPRU 2.1.73R) which equal or exceed:

- (1) the higher of:
 - (a) the funds under management requirement (in accordance with GENPRU 2.1.66R) less the base capital resources requirement in GENPRU 2.1.48R); and
 - (b) the fixed overheads requirement (in accordance with GENPRU 2.1.53R); plus
- (2) whichever is applicable of:
 - (a) the professional negligence capital requirement (in accordance with GENPRU 2.1.67R(1)(a); or
 - (b) the PII capital requirement (in accordance with GENPRU 2.1.67R(1)(b)).

- 2.1.65 G (1) The professional negligence capital requirement is applicable for a collective portfolio investment management firm which, in accordance with GENPRU 2.1.67R(1)(a), decides to cover professional liability risks by way of own funds.
- (2) The PII capital requirement is applicable for a collective portfolio management investment firm which, in accordance with GENPRU 2.1.67R(1)(b), decides to cover professional liability risks by way of professional indemnity insurance.
- 2.1.66 R The funds under management requirement is (subject to a maximum of €10,000,000) the sum of:
- (1) the base capital resources requirement; plus
 - (2) 0.02% of the amount by which the funds under management exceed €250,000,000.

[Note: article 9(3) of AIFMD and article 7(1)(a)(i) of the *UCITS Directive*]

- 2.1.67 R A firm must:
- (1) cover the professional liability risks set out in article [x] of the AIFMD level 2 regulation (professional liability risks) (as replicated in GENPRU 2.1.68EU) by either:
 - (a) maintaining an amount of own funds in accordance with the provisions of article [x] of the AIFMD level 2 regulation (additional own funds) (as replicated in GENPRU 2.1.70EU) (the professional negligence capital requirement); or
 - (b) holding professional indemnity insurance and maintaining an

amount of own funds to meet the PII capital requirement in accordance with the provisions of article [x] of the AIFMD level 2 regulation (professional indemnity insurance) (as replicated in GENPRU 2.1.71EU) and GENPRU 2.1.72R; and

- (2) comply with the qualitative requirements addressing professional liability risks set out in article [x] of the AIFMD level 2 regulation (qualitative requirements addressing professional liability) (as replicated in GENPRU 2.1.69EU).

[Note: article 9(7) of AIFMD]

- 2.1.68 EU [Article [x] of the AIFMD level 2 regulation (professional liability risks) to be inserted]
- 2.1.69 EU [Article [x] of the AIFMD level 2 regulation (qualitative requirements addressing professional liability) to be inserted]
- 2.1.70 EU [Article [x] of the AIFMD level 2 regulation (additional own funds) to be inserted]
- 2.1.71 EU [Article [x] of the AIFMD level 2 regulation (professional indemnity insurance) to be inserted]
- 2.1.72 R If a firm satisfies the requirement in GENPRU 2.1.67R with professional indemnity insurance it must, in addition to maintaining an amount of own funds to cover any defined excess, hold adequate own funds to cover any exclusions in the insurance policy that would otherwise result in the firm having insufficient resources to cover liabilities arising.
- 2.1.73 R For the purposes of GENPRU 2.1.64R, liquid assets are assets which:
- (1) are readily convertible to cash within one month; and
- (2) have not been invested in speculative positions.
- 2.1.74 G Examples of liquid assets that are acceptable for the purposes of GENPRU 2.1.73R include cash, readily realisable investments that are not held for short-term resale, and debtors.

[Note: article 9(8) of AIFMD]

Annex E

Amendments to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)

In this Annex new text is underlined and struck through text is deleted.

1.1 Application

...

- 1.1.3 G In the main *BIPRU* only applies to a ~~*UCITS investment firm*~~ *collective portfolio management investment firm* in respect of *designated investment business* (excluding ~~*scheme management activity*~~ *managing an AIF and managing a UCITS*). However *BIPRU* 2.2 (Internal capital adequacy standards), *BIPRU* 2.3 (Interest rate risk in the non-trading book), *BIPRU* 8 (Group risk - consolidation) and *BIPRU* 11 (Disclosure) apply to the whole of its business.

...

- 1.1.8 R A *firm* falling within *BIPRU* 1.1.6R(3) to *BIPRU* 1.1.6R(5) is a *BIPRU investment firm*. A *BIPRU investment firm* includes a ~~*UCITS investment firm*~~ *collective portfolio management investment firm* that is not excluded under *BIPRU* 1.1.7R.

...

Alternative classification of BIPRU investment firms

- 1.1.18 R *BIPRU investment firm* are divided into the following classes for the purposes of the calculation of the *base capital resources requirement* and for the purpose of any other provision of the *Handbook* that applies this classification:

- (1) a ~~*UCITS investment firm*~~ *collective portfolio management investment firm*;

...

Types of investment firm: BIPRU 125K firm

- 1.1.19 R A *BIPRU 125K firm* means a *BIPRU investment firm* that satisfies the following conditions:

...

- (4) it is not a ~~*UCITS investment firm*~~ *collective portfolio management investment firm*; and;

...

Types of investment firm: BIPRU 50K firm

- 1.1.20 R A *BIPRU 50K firm* means a *BIPRU investment firm* that satisfies the following conditions:

...

- (3) it is not a ~~UCITS investment firm~~ collective portfolio management investment firm; and

...

Types of investment firm: 730K firm

- 1.1.21 R A *BIPRU investment firm* that is not a ~~UCITS investment firm~~ collective portfolio management investment firm, a *BIPRU 50K firm* or a *BIPRU 125K firm* is a *BIPRU 730K firm*. A *BIPRU investment firm* that operates a *multilateral trading facility* is a *BIPRU 730k firm*.

...

8.5 Basis of consolidation

...

Basis of inclusion of ~~UCITS investment firms~~ collective portfolio management investment firms in consolidation

- 8.5.7 R *GENPRU 2.1.46R* (Adjustment of the variable capital requirement calculation for ~~UCITS investment firms~~ collective portfolio management investment firms) does not apply for the purpose of this chapter.
- 8.5.8 G In general a ~~UCITS investment firm~~ collective portfolio management investment firm only calculates its capital and concentration risk requirements in relation to its *designated investment business* and does not calculate them with respect to ~~scheme management activity~~ managing an AIF or managing a UCITS. The effect of *BIPRU 8.5.7R* is that this does not apply on a consolidated basis. For the purpose of this chapter the calculations are carried out with respect to the whole of the activities of a ~~UCITS investment firm~~ collective portfolio management investment firm.

Annex F

**Amendments to the Interim Prudential sourcebook for Investment Business
(IPRU(INV))**

In this Annex new text is underlined and struck through text is deleted unless otherwise indicated.

5 Chapter 5: Financial Resources

...

Exceptions from the liquid capital requirement

5.2.3(2) R ...

(ii) ...

(c) the *firm* is a trustee of an authorised unit trust scheme whose *permitted business* consists only of trustee activities and does not include any other activity constituting *specified trustee business* or the *firm* is a depositary of an ICVC or a PE AIF depositary whose *permitted business* consists only of *depositary activities*.

...

Own funds requirement

5.2.3(3) R The *own funds requirement* for a *firm* subject to rule 5.2.3(2) is:
(a)

(i) £4,000,000 for a firm which is a trustee of an authorised unit trust scheme or a depositary of an ICVC;

(ia) €125,000 for *firm* which is a PE AIF depositary; and

(ii) £5,000 for any other *firm*.

The following text is new and is not underlined.

7 Chapter 7: Collective Portfolio Management Firms and Internally Managed AIFs

7.1 Introduction

Application

7.1.1 R This chapter applies to:

- (1) a *collective portfolio management firm*; and
- (2) an *internally managed AIF*.

7.1.2 G An *internally managed AIF* is not permitted to engage in activities other than the management of that *AIF*. A *collective portfolio management firm* may manage *AIFs* and/or *UCITS*, provided it has *permission* to do so. A *collective portfolio management firm* may also undertake any of the additional investment activities permitted by article 6(4) of *AIFMD* or article 6(3) of the *UCITS Directive* (as applicable), provided it has *permission* to do so, but if so it is subject to *GENPRU* and *BIPRU* rather than *IPRU(INV)* and is classified as a *collective portfolio management investment firm*, as opposed to a *collective portfolio management firm*.

Relevant accounting principles

- 7.1.3 R
- (1) Except where a *rule* makes a different provision, terms referred to in this chapter must have the meaning given to them in the Companies Act 2006 or the *firm's* accounting framework (usually *UK* generally accepted accounting principles or *IFRS*) where defined in that Act or framework.
 - (2) Accounting policies must be the same as those adopted in the *firm's annual report and accounts* and must be consistently applied.

Purpose

- 7.1.4 G
- (1) This chapter amplifies *threshold condition 4* (Adequate resources) by providing that a *firm* must meet, on a continuing basis, a minimum capital resources requirement. This chapter also amplifies *Principles 3* and *4* which require a *firm* to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems and to maintain adequate financial resources by setting out a capital resources requirement for a *firm* according to the *regulated activity* or activities it carries on.
 - (2) This chapter also implements relevant requirements of *AIFMD* and the *UCITS Directive*, which among other matters impose capital and professional indemnity insurance requirements on an *AIFM* and a

UCITS management company.

7.2 Main requirements

Collective portfolio management firm

7.2.1 R A *collective portfolio management firm* must:

- (1) at the time that it first becomes a *collective portfolio management firm*, hold *initial capital* of not less than the applicable *base capital resources requirement* (in accordance with *IPRU(INV)* 7.3.1R(1));
- (2) at all times, maintain *own funds* which equal or exceed:
 - (a) the higher of:
 - (i) the *funds under management requirement* (in accordance with *IPRU(INV)* 7.3.2R); and
 - (ii) the *fixed overheads requirement* (in accordance with *IPRU(INV)* 7.3.4R); plus
 - (b) whichever is applicable of:
 - (i) the *professional negligence capital requirement* (in accordance with *IPRU(INV)* 7.3.12R(1)(a)); or
 - (ii) the *PII capital requirement* (in accordance with *IPRU(INV)* 7.3.12R(1)(b)); and
- (3) at all times, hold liquid assets (in accordance with *IPRU(INV)* 7.3.18R) which equal or exceed:
 - (a) the higher of:
 - (i) the *funds under management requirement* (in accordance with *IPRU(INV)* 7.3.2R) less the *base capital resources requirement* (in accordance with *IPRU(INV)* 7.3.1R(1)); and
 - (ii) the *fixed overheads requirement* (in accordance with *IPRU(INV)* 7.3.4R); plus
 - (b) whichever is applicable of:
 - (i) the *professional negligence capital requirement* (in accordance with *IPRU(INV)* 7.3.12R(1)(a)); or
 - (ii) the *PII capital requirement* (in accordance with *IPRU(INV)* 7.3.12R(1)(b)).

Internally managed AIF

7.2.2 R An *internally managed AIF* must:

- (1) at the time that it first becomes an *internally managed AIF*, hold *initial capital* of not less than the applicable *base capital resources requirement* (in accordance with *IPRU(INV)* 7.3.1R(2));
- (2) at all times, maintain *own funds* which equal or exceed:
 - (a) the *base capital resources requirement* (in accordance with *IPRU(INV)* 7.3.1R(2)); plus
 - (b) whichever is applicable of:
 - (i) the *professional negligence capital requirement* (in accordance with *IPRU(INV)* 7.3.12R(1)(a)); or
 - (ii) the *PII capital requirement* (in accordance with *IPRU(INV)* 7.3.12R(1)(b)); and.
- (3) at all times hold liquid assets (in accordance with *IPRU(INV)* 7.3.18R) which equal or exceed (whichever is applicable of):
 - (a) the *professional negligence capital requirement* (in accordance with *IPRU(INV)* 7.3.12R(1)(a)); or
 - (b) the *PII excess capital requirement* (in accordance with *IPRU(INV)* 7.3.12R(1)(b)).

Professional negligence

- 7.2.3 G (1) The *professional negligence capital requirement* is applicable for a *collective portfolio management firm* that manages an *AIF* and an *internally managed AIF* which, in accordance with *IPRU(INV)* 7.3.12R(1)(a), covers professional liability risks by way of *own funds*.
- (2) The *PII capital requirement* is applicable for a *collective portfolio management firm* that manages an *AIF* and an *internally managed AIF* which in accordance with *IPRU(INV)* 7.3.12R(1)(b) decides to cover professional liability risks by way of professional indemnity insurance.

7.3 Detail of main requirements

Base capital resources requirement

- 7.3.1 R The *base capital resources requirement* for a *firm* is:
- (1) €125,000 in the case of a *collective portfolio management firm*; and
 - (2) €300,000 in the case of an *internally managed AIF*.

[**Note:** article 9(1), (2) and (10) of *AIFMD* and article 7(1)(a) of the *UCITS Directive*]

Funds under management requirement

- 7.3.2 R The *funds under management requirement* is (subject to a maximum of €10,000,000) the sum of:
- (1) the *base capital resources requirement*; plus
 - (2) 0.02% of the amount by which the *funds under management* exceed €250,000,000.

[**Note:** article 9(3) of *AIFMD* and article 7(1)(a)(i) of the *UCITS Directive*]

Fixed overheads requirement

- 7.3.4 R The *fixed overheads requirement* is one quarter (13/52) of the *firm's* relevant fixed expenditure calculated in accordance with *IPRU(INV)* 7.3.5R.

[**Note:** article 9(5) of *AIFMD* and article 7(1)(a)(iii) of the *UCITS Directive*]

- 7.3.5 R For the purposes of *IPRU(INV)* 7.3.4R, and subject to *IPRU(INV)* 7.3.7R to *IPRU(INV)* 7.3.10R, a *firm's* relevant fixed expenditure is the amount described as total expenditure in its final income statement (FSA030) for the previous financial year, less the following items (if they are included within such expenditure):
- (1) staff bonuses, except to the extent that they are guaranteed;
 - (2) *employees'* and *directors'* shares in profits, except to the extent that they are guaranteed;
 - (3) other appropriations of profits;
 - (4) shared *commission* and fees payable which are directly related to *commission* and fees receivable which are included within total revenue;
 - (5) interest charges in respect of borrowings made to finance the acquisition of the *firm's readily realisable investments*;
 - (6) interest paid to *customers* on *client money*;
 - (7) interest paid to *counterparties*;
 - (8) fees, brokerage and other charges paid to *clearing houses*, exchanges and *intermediate brokers* for the purposes of *executing*, registering or clearing transactions;
 - (9) foreign exchange losses; and
 - (10) other variable expenditure.

- 7.3.6 G The income statement (FSA030) should be completed on a cumulative basis,

so that the final income statement in a *firm's* financial year (ie the period that ends on the *firm's accounting reference date*) relates to the entire year.

- 7.3.7 R The relevant fixed expenditure of a *firm* is:
- (1) where its final income statement (FSA030) for the previous financial year does not relate to a twelve-month period, an amount calculated in accordance with *IPRU(INV)* 7.3.5R, pro-rated so as to produce an equivalent twelve-month amount; or
 - (2) where it has not completed twelve months' trading, an amount based on forecast expenditure included in the budget for the first twelve months' trading, as submitted with its application for *authorisation*.
- 7.3.8 R A *firm* must adjust its relevant fixed expenditure calculation so far as necessary to the extent that since the submission of its final income statement (FSA030) for the previous financial year or since the budget was prepared (if *IPRU(INV)* 7.3.7R(2) applies):
- (1) its level of fixed expenditure changes materially; or
 - (2) its *regulated activities* comprised within its *permission* change.
- 7.3.9 G For the purpose of *IPRU(INV)* 7.3.5R to *IPRU(INV)* 7.3.8R, fixed expenditure is expenditure which is inelastic relative to fluctuations in a *firm's* levels of business. Fixed expenditure is likely to include most salaries and staff costs, office rent, payment for the rent or lease of office equipment, and insurance *premiums*. It may be viewed as the amount of funds which a *firm* would require to enable it to cease business in an orderly manner, should the need arise. This is not an exhaustive list of such expenditure and a *firm* will itself need to identify (taking appropriate advice where necessary) which costs amount to fixed expenditure.
- 7.3.10 R If a *firm* has a material proportion of its expenditure incurred on its behalf by another *person* and such expenditure is not fully recharged by that *person* then the *firm* must adjust its relevant fixed expenditure calculation by adding back in the whole of the difference between the amount of the expenditure and the amount recharged.
- 7.3.11 G For the purpose of *IPRU(INV)* 7.3.10R, the *FCA* would consider as material 10% of a *firm's* expenditure incurred on its behalf by other *persons*.

Professional negligence

- 7.3.12 R A *firm* that is a *collective portfolio management firm* that manages an *AIF* or an *internally managed AIF* must:
- (1) cover the professional liability risks set out in article [x] of the *AIFMD level 2 regulation* (professional liability risks) (as replicated in *IPRU(INV)* 7.3.13EU) by either:

- (a) maintaining an amount of *own funds* in accordance with article [x] of the *AIFMD level 2 regulation* (additional own funds) (as replicated in *IPRU(INV)* 7.3.15EU) (the *professional negligence capital requirement*); or
 - (b) holding professional indemnity insurance and maintaining an amount of *own funds* to meet the *PII capital requirement* in accordance with article [x] of the *AIFMD level 2 regulation* (professional indemnity insurance) (as replicated in *IPRU(INV)* 7.3.16EU and *IPRU(INV)* 7.3.17R; and
- (2) comply with the qualitative requirements addressing professional liability risks set out in article [x] of the *AIFMD level 2 regulation* (professional liability risks) (as replicated in [*IPRU(INV)* 7.3.14EU).

[**Note:** article 9(7) of *AIFMD*]

- 7.3.13 EU [Article [x] of the *AIFMD level 2 regulation* (professional liability risks) to be inserted]
- 7.3.14 EU [Article [x] of the *AIFMD level 2 regulation* (qualitative requirements addressing professional liability) to be inserted]
- 7.3.15 EU [Article [x] of the *AIFMD level 2 regulation* (additional own funds) to be inserted]
- 7.3.16 EU [Article [x] of the *AIFMD level 2 regulation* (professional indemnity insurance) to be inserted]
- 7.3.17 R If a *firm* satisfies the requirement in *IPRU(INV)* 7.3.12R with professional indemnity insurance it must, in addition to maintaining an amount of *own funds* to cover any defined excess, hold adequate *own funds* to cover any exclusions in the insurance policy that would otherwise result in the *firm* having insufficient resources to cover liabilities arising.

Liquid assets

- 7.3.18 R For the purposes of this chapter, liquid assets are assets which:
 - (1) are readily convertible to cash within one month; and
 - (2) have not been invested in speculative positions.
- 7.3.19 G Examples of liquid assets that are acceptable for the purposes of *IPRU(INV)* 7.3.18R include cash, *readily realisable investments* that are not held for short-term resale, and debtors.

[**Note:** article 9(8) of *AIFMD*]

7.4 Method of calculating initial capital and own funds

TABLE 7.4			
PART I			
A firm must calculate its <i>initial capital</i> and <i>own funds</i> as shown below, subject to the detailed requirements set out in Part II.			
Paragraph		Category	Part II
TIER 1			
(1)	Paid-up share capital (excluding preference shares)	A	2
(2)	Share premium account		
(3)	Audited reserves and interim profits		3 and 4
(4)	Non-cumulative preference shares		
(5)	<i>Eligible LLP members' capital</i>		5
Initial capital = A			
(6)	Investments in own shares	B	
(7)	Intangible assets		6
(8)	Material current year losses		7
(9)	<i>Excess LLP members' drawings</i>		
(10)	Material holdings in credit and financial institutions		8
Tier 1 capital = (A-B) =		C	
TIER 2			1(b)
(11)	Revaluation reserves	D	
(12)	Fixed term cumulative preference share capital		1(a)

(13)	Long-term <i>qualifying subordinated loans</i>		1(a); 9
(14)	Other cumulative preference share capital and debt capital		
(15)	Qualifying arrangements		10
OWN FUNDS = (C+D) =		E	

PART II DETAILED REQUIREMENTS

1	Ratios
(a)	The total of fixed-term cumulative preference share capital (item 12) and long-term <i>qualifying subordinated loans</i> (item 13) that may be included in Tier 2 capital (D) is limited to 50 per cent of Tier 1 capital (C); and
(b)	Tier 2 capital (D) must not exceed 100 per cent of Tier 1 capital (C).
2	Non corporate entities
(a)	In the case of partnerships, the following terms should be substituted, as appropriate, for items 1 to 4 in <i>initial capital</i> :
(i)	partners' capital accounts (excluding loan capital);
(ii)	partners' current accounts (excluding unaudited profits and loan capital); and
(iii)	proprietor's account (or other term used to signify the sole trader's capital but excluding unaudited profits).
(b)	Loans other than <i>qualifying subordinated loans</i> shown within partners' or proprietors' accounts must be classified as Tier 2 capital under item 14.
(c)	For the calculation of <i>initial capital</i> and <i>own funds</i> , partners' current accounts figures are subject to the following adjustments in respect of a <i>defined benefit occupational pension scheme</i> :
(i)	a <i>firm</i> must derecognise any <i>defined benefit</i> asset: and
(ii)	a <i>firm</i> may substitute for <i>defined benefit liability</i> the <i>firm's deficit reduction amount</i> . The election must be applied

			consistently in respect of any one financial year.
Note			
A <i>firm</i> should keep a record of and be ready to explain to its supervisory contacts in the <i>FCA</i> the reasons for any difference between the <i>deficit reduction amount</i> and any commitment the <i>firm</i> has made in any public document to provide funding in respect of a <i>defined benefit occupational pension scheme</i> .			
3	Audited Reserves (Item 3)		
For the calculation of <i>initial capital</i> and <i>own funds</i> , the following adjustments apply to the audited reserves figure:			
	(a)	a <i>firm</i> must deduct any unrealised gains or, where applicable, add back in any unrealised losses on cash flow hedges of <i>financial instruments</i> measured at cost or amortised cost:	
	(b)	in respect of a <i>defined benefit occupational pension scheme</i> , a <i>firm</i> must derecognise any <i>defined benefit asset</i> ; and	
	(c)	a <i>firm</i> may substitute for a <i>defined benefit liability</i> the <i>firm's deficit reduction amount</i> . The election must be applied consistently in respect of any one financial year.	
Note			
A <i>firm</i> should keep a record of, and be ready to explain to its supervisory contacts in the <i>FCA</i> , the reasons for any difference between the <i>deficit reduction amount</i> and any commitment the <i>firm</i> has made in any public document to provide funding in respect of a <i>defined benefit occupational pension scheme</i> .			
	(d)	a <i>firm</i> must not include any unrealised gains from investment property.	
Note			
Unrealised gains from investment property should be reported as part of revaluation reserves.			
	(e)	where applicable, a <i>firm</i> must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but excluding from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.	

4	Interim profits (Item 3)
Non-trading book interim profits may only be included in Tier 1 of the calculation if they have been independently verified by the <i>firm's</i> auditor.	
For this purpose, the auditor should normally undertake at least the following:	
(a)	satisfy himself that the figures forming the basis of the interim profits have been properly extracted from the underlying accounting records;
(b)	review the accounting policies used in calculating the interim profits so as to obtain comfort that they are consistent with those normally adopted by the <i>firm</i> in drawing up its annual financial statements;
(c)	perform analytical review procedures on the results to date, including comparisons of actual performance to date with budget and with the results of prior periods;
(d)	discuss with management the overall performance and financial position of the <i>firm</i> ;
(e)	obtain adequate comfort that the implications of current and prospective litigation, all known claims and commitments, changes in business activities and provisions for bad and doubtful debts have been properly taken into account in arriving at the interim profits; and
(f)	follow up problem areas of which the auditor is already aware in the course of auditing the <i>firm's</i> financial statements.
A <i>firm</i> wishing to include interim profits in Tier 1 capital must obtain a verification report signed by its auditor which states whether the interim results are fairly stated.	
Profits on the sale of capital items or arising from other activities which are not directly related to the <i>designated investment business</i> of the <i>firm</i> may also be included within the calculation of <i>own funds</i> if they can be separately verified by the <i>firm's</i> auditor. In such a case, such profits can form part of the <i>firm's</i> Tier 1 capital as audited profits.	
5	Eligible LLP members' capital (Item 5)
Members' capital of a <i>limited liability partnership</i> may only be included in	

initial capital (see item 5) if the conditions in *IPRU(INV)* Annex A 2.2R (Specific conditions for eligibility) and *IPRU(INV)* Annex A 2.3R (General conditions for eligibility) are satisfied.

6 Intangible assets (Item 7)

Intangible assets comprise:

- (a) formation expenses to the extent that these are treated as an asset in the *firm's* accounts;
- (b) goodwill, to the extent that it is treated as an asset in the *firm's* accounts; and
- (c) other assets treated as intangibles in the *firm's* accounts.

7 Material current year losses (Item 8)

Losses in current year operating figures must be deducted when calculating Tier 1 capital if such losses are material. For this purpose profits and losses must be calculated quarterly, as appropriate. If this calculation reveals a net loss it shall only be deemed to be material for the purposes of this Table if it exceeds 10 per cent of the *firm's* Tier 1 capital.

8 Material holdings in credit and financial institutions (Item 10)

Material holdings comprise:

- (a) where the *firm* holds more than 10 per cent of the equity share capital of a *credit institution* or *financial institution*, the value of that holding and the amount of any subordinated loans to that institution and the value of holdings in *qualifying capital items* or *qualifying capital instruments* issued by that institution;
- (b) in the case of holdings other than those mentioned in (a) above, the value of holdings of equity share capital in, and the amount of subordinated loans made to, such institutions and the value of holdings in *qualifying capital items* or *qualifying capital instruments* issued by such institutions to the extent that the total of such holdings and subordinated loans exceeds 10 per cent of the *firm's own funds* calculated before the deduction of item 10.

9	Long term <i>qualifying subordinated loans</i> (Item 13)
Loans having the characteristics prescribed by <i>IPRU(INV)</i> 7.5.1R may be included in item 13, subject to the limits set out in paragraph (1) above.	
10	Qualifying arrangements (Item 15)
A <i>firm</i> may only include an arrangement in item 15 if it is a <i>qualifying capital instrument</i> or a <i>qualifying capital item</i> .	

7.5 Qualifying subordinated loans

Characteristics of long-term qualifying subordinated loans

7.5.1 R A long term *qualifying subordinated loan* (item 13 of Table 7.4) must have the following characteristics:

- (1) the loan is repayable only on maturity or on the expiration of a period of notice in accordance with paragraph (3) below or on the winding up of the *firm*;
- (2) in the event of the winding up of the *firm*, the loan ranks after the claims of all other creditors and is not to be repaid until all other debts outstanding at the time have been settled;
- (3) either:
 - (a) the minimum original maturity of the loan is five years; or
 - (b) the loan does not have a minimum or fixed maturity but requires five years notice of repayment; and
- (4) the loan is fully paid-up.

[**Note:** article 4(1)(ad) of *AIFMD*, article 2(1)(l) of the *UCITS Directive* and article 64(3) of the *Banking Consolidation Directive*]

Amount allowable in the calculation of own funds

7.5.2 R A *firm* may only take into account the paid-up amount of a long term *qualifying subordinated loan* in the calculation of its *own funds*. This amount must be amortised on a straight-line basis over the five years prior to the date of repayment.

[**Note:** article 4(1)(ad) of *AIFMD*, article 2(1)(l) of the *UCITS Directive* and article 64(3)(c) of the *Banking Consolidation Directive*]

Form of qualifying subordinated loan agreement

- 7.5.3 R A *qualifying subordinated* loan must be in the form prescribed for Chapter 5 of *IPRU(INV)* by Annex D to *IPRU(INV)* with the following changes:
- (1) the reference to “Chapter 5” in Recital B on page 2 deleted and replaced with a reference to “Chapter 7”; and
 - (2) the references to “rule 5.2.1(1) of Chapter 5” in clause 3(b) (Interest) deleted and replaced with a reference to “rule 7.2.1 (collective portfolio management firm) of Chapter 7” or “rule 7.2.2 (internally managed AIF) of Chapter 7” (as applicable).

Requirements on a firm in relation to qualifying subordinated loans

- 7.5.4 R A *firm* including a *qualifying subordinated loan* in its calculation of *own funds* must not:
- (1) secure all or any part of the loan; or
 - (2) redeem, purchase or otherwise acquire any of the liabilities of the borrower in respect of the loan; or
 - (3) amend or concur in amending the terms of the loan agreement; or
 - (4) repay all or any part of the loan otherwise than in accordance with the terms of the loan agreement; or
 - (5) take or omit to take any action whereby the subordination of the loan or any part thereof might be terminated, impaired or adversely affected.

Annex G

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex underlining indicates new text and striking through indicates deleted text.

2.1 Acting honestly, fairly and professionally

The client's best interests rule

- 2.1.1 R (1) A *firm* must act honestly, fairly and professionally in accordance with the best interests of its *client* (the *client's best interests rule*).

...

- (4) This rule applies in relation to:

- (a) a full scope UK AIFM of:

- (i) a UK AIF;

- (ii) an EEA AIF managed or marketed from an establishment in the United Kingdom; and

- (iii) a non-EEA AIF; and

- (b) an incoming EEA AIFM branch which manages or markets a UK AIF.

[**Note:** article 19(1) of *MiFID*, ~~and~~ article 14(1)(a) and (b) of the *UCITS Directive* and article 12(1)(b) of *AIFMD*]

Treating investors fairly

- 2.1.4 R A full scope UK AIFM and an incoming EEA AIFM branch must:

- (1) treat all investors in any AIF it manages fairly; and
 (2) not allow any investor in an AIF it manages to obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF's instrument constituting the fund.

[**Note:** article 12(1)(f) and article 12(1) first paragraph of *AIFMD*]

Subordinate measures for alternative investment fund managers

[**Note:** articles [x] to [y] of the *AIFMD level 2 regulation* lay down detailed rules supplementing the relevant provisions of Article 12(1) of *AIFMD*]

Annex H

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text and striking through indicates deleted text except where indicated otherwise.

16.12 Integrated Regulatory Reporting

...

Reporting requirement

...

16.12.4 R Table of applicable rules containing *data items*, frequency and submission periods

(1)		(2)	(3)	(4)
RAG number	Regulated Activities	Provisions containing:		
		applicable <i>data items</i>	reporting frequency/period	Due date
...				
RAG 4	- managing investments - establishing, operating or winding up a <u>regulated</u> collective investment scheme establishing, operating or winding up an unregulated collective investment scheme - establishing, operating or winding up a stakeholder	SUP 16.12.14R SUP 16.12.15R	SUP 16.12.14R SUP 16.12.16R	SUP 16.12.14R SUP 16.12.17R

	pension scheme • establishing, operating or winding up a personal pension scheme • <u>managing an AIF</u> • <u>managing a UCITS</u>			
...				
RAG 6	• acting as a trustee of an authorised unit trust • safeguarding and administration of assets (without arranging) • arranging safeguarding and administration of assets • acting as depository or sole director of an OEIC • <u>acting as a depository of an AIF</u> • <u>acting as a depository of a UCITS</u>	SUP 16.12.19R	SUP 16.12.20R	SUP 16.12.21R

...

Regulated Activity Group 3

...

16.12.11 R The applicable *data items* referred to in SUP 16.12.4R are set out according to *firm* type in the table below:

Description of data item	Firms prudential category and applicable data items (note 1)							
	BIPRU firms (note 17)			Firms other than BIPRU firms				
	730K	125K and <u>UCITS investment firms collective portfolio management investment firms</u>	50K	<u>IPRU (INV)</u> Chapter 3	<u>IPRU (INV)</u> Chapter 5	<u>IPRU (INV)</u> Chapter 9	<u>IPRU (INV)</u> Chapter 13	<u>UPRU</u>
Annual report and accounts	...	...	...	...	...	...	...	No standard format
...								
Solvency statement	...	...	...	...	...	...	...	No standard format (note 11)
Balance sheet	...	...	...	...	...	...	...	FSA029
Income statement	...	...	...	...	...	...	...	FSA030
Capital adequacy	...	...	...	...	...	...	...	FSA036
<u>Supplementary capital data for collective portfolio management investment firms</u>		FSA067 (note 35)						
Credit risk								
...								

Client money and client assets	...	...	...	...	...	...	...	FSA039
CFTC	...	...	...	...	...	...	...	FSA040 (note 24)
...								
<u>Note 35</u>	<u>Only applicable to firms that are collective portfolio management investment firms.</u>							
...								

...

- 16.12.12 R The applicable reporting frequencies for *data items* referred to in SUP 16.12.4R are set out in the table below according to *firm* type. Reporting frequencies are calculated from a *firm's accounting reference date*, unless indicated otherwise.

<i>Data item</i>	<i>BIPRU 730K firm</i>	<i>BIPRU 125K firm and UCITS investment firm collective portfolio management investment firm</i>	<i>BIPRU 50K firm</i>	<i>UK consolidation group or defined liquidity group</i>	<i>Firm other than BIPRU firms</i>
...					
FSA036	...	...	...		Quarterly
...					
FSA058	...	...	...	...	
<u>FSA067</u>		<u>Quarterly</u>			
...					

- 16.12.13 R The applicable due dates for submission referred to in SUP 16.12.4R are set out in the table below. The due dates are the last day of the periods given in the table below following the relevant reporting frequency period set out in

SUP 16.12.12R, unless indicated otherwise.

<i>Data item</i>	Daily	Weekly	Monthly	Quarterly	Half yearly	Annual
...						
FSA036				20 business days		
...						
FSA058						
<u>FSA067</u>				<u>20 business days</u>		
...						

...

Regulated Activity Group 4

...

16.12.15 R The applicable *data items* referred to in SUP 16.12.4R according to type of *firm* are set out in the table below:

Description of data item	<i>Firms' prudential category and applicable data items (note 1)</i>								
	<i>BIPRU firms</i>			<i>Firms other than BIPRU firms</i>					
	730K	125K and UCITS investment firms collective portfolio management investment firms	50K	IPRU (INV) Chapter 3	IPRU (INV) Chapter 5	IPRU (INV) Chapter 7	IPRU (INV) Chapter 9	IPRU (INV) Chapter 13	UPRU
<i>Annual report and accounts</i>	...	...	...	...	...	<u>No standard format</u>	...	...	<u>No standard format (note 13)</u>
...									
Solvency statement (note 11)	...	...	...		...	<u>No standard format</u>			<u>No standard format</u>

Balance sheet	...	...	...	...	...	<u>FSA029</u>	...	...	FSA029
Income statement	...	...	...	...	...	<u>FSA030</u>	...	...	FSA030
Capital adequacy	...	...	...	...	...	<u>FSA066</u>	...	...	FSA036
<u>Supplementary capital data for collective portfolio management investment firms</u>		<u>FSA067 (note 32)</u>							
...									
Volumes and types of business (note 21)	...	...	...	...	...	<u>FSA038</u>	...	...	FSA038
Client money and client assets	...	...	...	...	...	<u>FSA039</u>	...	...	FSA039
Asset managers that use hedge fund techniques (note 21)	FSA041	FSA041	FSA041	FSA041	FSA041		FSA041	FSA041	FSA041
UCITS (note 22)	FSA042	FSA042	FSA042	FSA042	FSA042	<u>FSA042</u>	FSA042	FSA042	FSA042
...									
Note 21	Only applicable to firms that have a managing investments permission [deleted]								
Note 22	Only applicable to firms that have permission for establishing, operating or winding up a regulated collective investment scheme <u>managing a UCITS</u> .								
...									
<u>Note 32</u>	<u>Only applicable to firms that are collective portfolio management investment firms.</u>								

...

- 16.12.16 R The applicable reporting frequencies for *data items* referred to in SUP 16.12.15R are set out in the table below according to *firm* type. Reporting frequencies are calculated from a *firm's accounting reference date*, unless

indicated otherwise.

<i>Data item</i>	<i>Firms' prudential category</i>				
	<i>BIPRU 730K firm</i>	<i>BIPRU 125K firm and UCITS investment firm collective portfolio management investment firm</i>	<i>BIPRU 50K firm</i>	<i>UK consolidation group or defined liquidity group</i>	<i>Firm other than BIPRU firms</i>
...					
<u>FSA036</u>					<u>Quarterly</u>
...					
<u>FSA041</u>	<u>Annually</u>	<u>Annually</u>	<u>Annually</u>		<u>Annually</u>
<u>FSA042</u>	<u>Quarterly</u>	<u>Quarterly</u>	<u>Quarterly</u>		<u>Quarterly</u>
...					
<u>FSA058</u>	...	...	...	...	
<u>FSA066</u>					<u>Quarterly</u>
<u>FSA067</u>		<u>Quarterly</u>			
...					

16.12.17 R The applicable due dates for submission referred to in SUP 16.12.4R are set out in the table below. The due dates are the last day of the periods given in the table below following the relevant reporting frequency period set out in SUP 16.12.16R, unless indicated otherwise.

<i>Data item</i>	Daily	Weekly	Monthly	Quarterly	Half yearly	Annual
...						
<u>FSA036</u>				<u>20 business days</u>		
...						

FSA041						30 business days
...						
FSA058				...		
<u>FSA066</u>				<u>20 business days</u>		
<u>FSA067</u>				<u>20 business days</u>		
...						

...

Regulated Activity Group 6

...

16.12.19 R The applicable *data items* referred to in SUP 16.12.4R are set out according to type of *firm* in the table below:

Description of <i>data item</i>	<i>Firm's</i> prudential category and applicable data item (note 1)				
	<i>IPRU(INV)</i> Chapter 3	<i>IPRU(INV)</i> Chapter 5	<i>IPRU(INV)</i> Chapter 9	<i>IPRU(INV)</i> Chapter 13	<i>UPRU</i>
<i>Annual report and accounts</i>	No standard format				
Solvency statement (note 6)					No standard format
Balance sheet					FSA029
Income statement					FSA030
Capital adequacy					FSA036
Threshold conditions					
Client money and					FSA039

client assets					
...					

- 16.12.20 R The applicable reporting frequencies for submission of *data items* referred to in SUP 16.12.4R are set out in the table below. Reporting frequencies are calculated from a *firm's accounting reference date*, unless indicated otherwise.

...	
FSA036	Quarterly
...	

- 16.12.21 R The applicable due dates for submission referred to in SUP 16.12.4R are set out in the table below. The due dates are the last day of the periods given in the table below following the relevant reporting frequency period set out in SUP 16.12.20R.

<i>Data item</i>	Quarterly	Half yearly	Annual
...			
FSA036	20 <i>business days</i>		
...			

...

Regulated Activity Group 7

...

- 16.12.22 R The applicable *data items* referred to in SUP 16.12.4R are set out according to type of *firm* in the table below:

Description of <i>Data item</i>	<i>Firms' prudential category and applicable data item (note 1)</i>					
	<i>BIPRU 730k firm</i>	<i>BIPRU 125k firm and UCITS investment firm collective portfolio management investment</i>	<i>BIPRU 50k firm</i>	<i>Exempt CAD firms subject to IPRU(INV) Chapter 13</i>	<i>Firms (other than exempt CAD firms) subject to IPRU(INV) Chapter 13</i>	<i>Firms that are also in one or more of RAGs 1 to 6 and not subject to IPRU(INV) Chapter 13</i>

		<i>firm</i>				
...						
Securitisation: trading book	...	...	...			
<u>Supplementary capital data for collective portfolio management investment firms</u>		<u>FSA067 (note 28)</u>				
...						
<u>Note 28</u>	<u>Only applicable to firms that are collective portfolio management investment firms.</u>					
...						

...

- 16.12.23 R The applicable reporting frequencies for *data items* referred to in *SUP* 16.12.22AR are set out in the table below. Reporting frequencies are calculated from a *firm's accounting reference date*, unless indicated otherwise.

<i>Data item</i>	Frequency				
	Unconsolidated <i>BIPRU investment firm</i>	Solo consolidated <i>BIPRU investment firm</i>	<i>UK Consolidation Group or defined liquidity group</i>	Annual regulated business revenue up to and including £5 million	Annual regulated business revenue over £5 million
...					
FSA058	...	...	...		
<u>FSA067</u>	<u>Quarterly</u>				
...					

- 16.12.24 R The applicable due dates for submission referred to in *SUP* 16.12.4R are set out in the table below. The due dates are the last day of the periods given in the table below following the relevant reporting frequency period set out in

SUP 16.12.23R, unless indicated otherwise.

<i>Data item</i>	Daily	Weekly	Monthly	Quarterly	Half yearly	Annual
...						
FSA058				...		
<u>FSA067</u>	<u>20 business days</u>					
...						

...

Regulated Activity Group 8

...

16.12.25 R The applicable *data items* referred to in SUP 16.12.4R are set out according to type of *firm* in the table below:

Description of <i>data item</i>	<i>Firms' prudential category and applicable data item (note 1)</i>							
	<i>BIPRU</i>			<i>Firms other than BIPRU firms</i>				
	730K	125K	50K	<i>IPRU (INV)</i> Chapter 3	<i>IPRU (INV)</i> Chapter 5	<i>IPRU (INV)</i> Chapter 9	<i>IPRU (INV)</i> Chapter 13	<i>UPRU</i>
<i>Annual report and accounts</i>	No standard format							
...								
Solvency statement (note 11)	...	...	...	...	...	...	...	No standard format
...								
Income statement	...	...	...	...	...	...	...	FSA030
Capital adequacy	...	...	...	...	...	...	...	FSA036
...								

Client money and client assets	...	...	...	...	...	...	...	FSA039
...								

...

- 16.12.26 R The applicable reporting frequencies for *data items* referred to in SUP 16.12.25AR are set out according to the type of *firm* in the table below. Reporting frequencies are calculated from a *firm's accounting reference date*, unless indicated otherwise.

<i>Data item</i>	<i>BIPRU 730K firm</i>	<i>BIPRU 125K firm</i>	<i>BIPRU 50K firm</i>	<i>UK consolidation group or defined liquidity group</i>	<i>Firms other than BIPRU firms</i>
...					
FSA036					Quarterly
...					

- 16.12.27 R The applicable due dates for submission referred to in SUP 16.12.4R are set out in the table below. The due dates are the last day of the periods given in the table below following the relevant reporting frequency period set out in SUP 16.12.26R, unless indicated otherwise .

<i>Data item</i>	Daily	Weekly	Monthly	Quarterly	Half yearly	Annual
...						
FSA036				20 business days		
...						

...

SUP 16 Annex 24R Data items for SUP 16.12

Forms FSA036 and FSA041 are deleted.

FSA066 and FSA06 are added - see following pages

SUP 16 Annex 25G Guidance notes for data items in SUP 16 Annex 24R

Guidance notes on Forms FSA036 and FSA041 are deleted

Guidance notes on Forms FSA066 and FSA067 are added - see following pages.

FSA066
Capital adequacy (for *collective portfolio management firms* and *internally managed AIFs*)

Regulatory Capital		A	B
Tier 1			
1	Paid up share capital (excluding preference shares)		
2	Share premium account		
3	Audited reserves		
4	Non-cumulative preference shares		
5	Eligible LLP member's capital		
6	Initial capital		
7	Less: Investment in own shares		
8	Intangible assets		
9	Material current year losses		
10	Excess LLP member's drawings		
11	Material holdings in credit and financial institutions		
12	Total deductions		
13	Tier 1 capital		
Tier 2			
14	Revaluation reserves		
15	Fixed term cumulative preference share capital		
16	Long term Qualifying Subordinated Loans		
17	Other cumulative preference share capital and debt capital		
18	Qualifying arrangements		
19	Own funds		
Regulatory capital tests			
Own funds test for collective portfolio management firms			
20	Own funds		
Higher of:			
21	Funds under management requirement		
and			
22	Fixed overheads requirement		
23	+ (either) Professional negligence capital requirement		
24	+ (or) PII capital requirement		
25	Total capital requirement		
26	Surplus / deficit of own funds		
Own funds test for internally managed AIFs			
27	Own funds		
28	Base capital resources requirement		
29	+ (either) Professional negligence capital requirement		
30	+ (or) PII capital requirement		
31	Surplus / deficit of own funds		

32	Liquid assets requirement
33	Liquid assets held
34	Surplus / deficit of liquid assets

35	Total expenditure (per income statement)
36	Less:
37	Staff bonuses, except to the extent they are guaranteed
38	Employees' and Directors shares in profits, except to the extent they are guaranteed
39	Other appropriations of profits
40	Allowable commission and fees
41	Interest charges in respect of borrowings made to finance the acquisition of
42	the firm's readily realisable investments
43	Interest paid to customers on client money
44	Interest paid to counterparties
45	Fees, brokerage and other charges paid to clearing houses, exchanges and
46	intermediate brokers for the purposes of executing, registering or clearing transactions
47	Foreign exchange losses
	Other variable expenditure
	Relevant fixed expenditure
	Relevant annualised fixed expenditure

[illegible]

48 Specify whether your firm holds additional own funds or PII in accordance with IPRU (INV) 7.3.12R

49 If PII is held, provide the following policy details

[illegible]

FSA066 – Capital Adequacy (for *collective portfolio management firms* and *internally managed AIFs*)

Introduction

The purpose is to provide a framework for the collection of prudential information required by the *FCA* as a basis for its supervision activities. The data item is intended to reflect the underlying prudential requirements contained in *IPRU(INV)* chapter 7 and allows monitoring against the requirements set out there.

Defined Terms

Terms referred to in these notes where defined by the Companies Act 2006, as appropriate, or the provisions of the *firm's* accounting framework (usually UK GAAP or *IFRS*) bear that meaning for these purposes. The descriptions indicated in these notes are designed simply to repeat, summarise or amplify the relevant statutory or other definitions and terminology without departing from their full meaning or effect.

- The data item should comply with the principles and requirements of the *firm's* accounting framework, which will generally be UK GAAP (including relevant provisions of the Companies Act 2006 as appropriate) or *IFRS*.
- The data item should be completed on an unconsolidated basis.
- The data item should be in agreement with the underlying accounting records.
- Accounting policies should be consistent with those adopted in the *firm's annual report and accounts* and should be consistently applied.
- Information required should be prepared in accordance with generally accepted accounting standards.
- The data item should not give a misleading impression of the *firm*. A data item is likely to give a misleading impression if a *firm* wrongly omits or includes a material item or presents a material item in the wrong way.

Currency

You should report in the currency of your annual audited accounts i.e. in either Sterling, Euro, US dollars, Canadian dollars, Swedish Kroner, Swiss Francs or Yen. Figures should be reported in 000s.

Data Elements

These are referred to by row first, then by column, so data element 2B will be the element numbered 2 in column B.

Regulatory capital		
	1 to 19	The figures entered in this section should be consistent with those entered in FSA029 submitted for the same reporting period.
Regulatory capital test		
<i>Own funds test for collective portfolio management firms</i>		
Own funds	20B	The amount of <i>own funds</i> calculated in accordance with <i>IPRU(INV)</i> 7.4. This is the figure entered at 19B.
Funds under management requirement	21B	Up to a maximum of €10,000,000, this is the <i>base capital resources requirement</i> plus 0.02% of the amount by which the <i>firm's funds under management</i> exceeds €250,000,000. If the data item is not being submitted with figures specified in Euros, then the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
Fixed overheads requirement	22B	This is one quarter of the annualised fixed expenditure calculated in accordance with

		<i>IPRU(INV) 7.3.4R.</i> The amount to be entered in this element is calculated using elements 35 to 47 in the fourth quarter of the preceding financial year. Each of the four quarters in any financial year should use the figure calculated in the fourth quarter of the preceding year. Where there was no preceding year, the figure entered is that determined in accordance with <i>IPRU(INV) 7.3.7R</i>
Professional negligence capital requirement	23B	This is the amount of additional <i>own funds</i> used to cover potential liability risks arising from professional negligence in relation to <i>AIFM</i> activities in lieu of professional indemnity insurance, as per <i>IPRU(INV) 7.3.12R(1)(a)</i> .
PII capital requirement	24B	This is the amount of any additional <i>own funds</i> required to cover any defined excess in the insurance policy, as required by <i>IPRU(INV) 7.3.12R(1)(b)</i> and any exclusions in the insurance policy that would otherwise result in the <i>firm</i> having insufficient resources to cover liabilities arising, as required by <i>IPRU(INV) 7.3.17R..</i>
Total capital requirement	25B	This is the higher of 21B and 22B, plus either 23B or 24B.
Surplus / deficit of own funds	26B	This is 20B less 25B.
<i>Own funds test for internally managed AIFs</i>		
Own funds	27B	The amount of <i>own funds</i> calculated in accordance with <i>IPRU(INV) 7.4R</i> . This is the figure entered at 19B.
Base capital resources requirement	28B	This is the requirement specified in <i>IPRU(INV) 7.3.1R</i> . If the data item is not being submitted with figures specified in Euros, then the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
Professional negligence capital requirement	29B	This is the amount of <i>own funds</i> used to cover potential liability risks arising from professional negligence in relation to <i>AIFM</i> activities in lieu of professional indemnity insurance, as per <i>IPRU(INV) 7.3.12R(1)(a)</i> .
PII capital requirement	30B	This is the amount of any additional <i>own funds</i> required to cover any defined excess in the insurance policy, as required by <i>IPRU(INV) 7.3.12R(1)(b)</i> and any exclusions in the insurance policy that would otherwise result in the <i>firm</i> having insufficient resources to cover liabilities arising, as required by <i>IPRU(INV) 7.3.17R.</i>
Surplus / deficit of own funds	31B	This is 27B less the total of 28B plus either 29B or 30B.
<i>Liquid assets test</i>		
Liquid assets requirement	32B	For a <i>colletive portfolio management firm</i>, this is the amount required by <i>IPRU(INV) 7.2.1R(3)</i>. For an <i>internally managed AIF</i>, this is the amount required by <i>IPRU(INV) 7.2.2 R(3)</i>.
Liquid assets held	33B	This is the amount of liquid assets held by the

		<i>firm</i> at the reporting date. Assets are regarded as liquid if they are readily convertible to cash within one month. This figure must not include speculative positions.
Surplus / deficit of liquid assets	34B	This is 33B less 32B.
Calculation of relevant annual expenditure for forthcoming year		
	35 to 47	This section of the data item must be completed when the reporting period end date is equal to the <i>firm's</i> accounting reference date, i.e. the fourth quarter. The section does not need to be completed during the other three quarters. Where appropriate, figures entered should match those on FSA030 for the same reporting period. When, as per <i>IPRU(INV)</i> 7.3.7R(2), the <i>firm</i> is using projected figures, these should be entered in this section.
Total expenditure (per income statement)	35B	This should be the amount entered in element 22A of FSA030 for the same reporting period. FSA030 is required to be completed on a cumulative basis, so the amounts entered in the fourth quarter represent the entire financial year up to the accounting reference date.
Deductions from expenditure	36A to 45A	Deductions from expenditure should be made in accordance with <i>IPRU(INV)</i> 7.3.5R
Relevant fixed expenditure	46B	This is 33B less the sum of 34A to 45A
Relevant annualised fixed expenditure	47B	If the figures submitted in FSA030 for the period ending on the <i>firm's</i> accounting reference date do not include twelve month's trading, then the amount calculated in 46B must be prorated to an equivalent annual amount. This situation may occur if the <i>firm</i> has changed its accounting reference date. Where a <i>firm</i> has not completed a full year since the commencement of its permitted business, an amount based on forecast expenditure included in its budget for the first twelve months' trading, as submitted with its application for membership should be entered.
Professional Indemnity Insurance		
Specify whether your firm holds additional own funds or PII in accordance with <i>IPRU(INV)</i> 7.3.12R	48B	The <i>firm</i> should report either "Own funds" or "PII". Where a <i>firm</i> has PII but also holds <i>own funds</i> to cover any excesses on the policy, the <i>firm</i> should report "PII".
<i>PII Basic information</i>		
	49	<i>Firms</i> should enter details on all relevant PII policies, using a separate line for each policy. If a group policy is held, each <i>firm</i> in the group should include the policy information on their return.
Annualised premium	49A	This should state the premium payable (in descending order of size, where relevant), net of tax and any other add-ons. If the premium covers a period other than 12 months, it should be annualised before ranking.
Insurer (from list)	49B	Select the PII insurer from the list provided. If you have more than one policy with the same insurer, they should be combined. If the insurer

		is not listed, select 'Other'. If a policy is underwritten by more than one insurance undertaking or Lloyd's syndicate, you should select 'multiple'.
Start date	49C	Enter the start date of the policy.
Renewal date	49D	Enter the renewal date of the policy.
Currency of indemnity limits	49E	Using the appropriate International Organization for Standardization ISO 4217 three digit code (e.g. GBP), enter the currency in which the indemnity limits, in fields 49F to 49J are reported.
Limit of indemnity required: single	49F	You should record here the required indemnity limits on the <i>firm's</i> PII policy or policies, in relation to single claims. Where these are denominated in a currency other than the currency of the report, the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
Limit of indemnity required: aggregate	49G	You should record here the required indemnity limits on the <i>firm's</i> PII policy or policies, in aggregate. Where these are denominated in a currency other than the currency of the report, the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
Limit of indemnity received: single	49H	You should record here the indemnity limits on the <i>firm's</i> PII policy or policies, received in relation to single claims. Where these are denominated in a currency other than the currency of the report, the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
Limit of indemnity received: aggregate	49J	You should record here the indemnity limits on the <i>firm's</i> PII policy or policies, received in aggregate. Where these are denominated in a currency other than the currency of the report, the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
<i>PII detailed information</i>		
Business line (from list)	49K	For policies that cover all business lines, <i>firms</i> should select 'All' from the list provided. Where the policy contains different excess for different business lines, <i>firms</i> should identify these business lines from the list (or the closest equivalent) and report the (highest) excess for that business line in data element 49L. Once these 'non-standard' excesses have been identified, the remaining business lines should be reported under 'All other'.
Policy excess	49L	For policies that cover all business lines with no difference in excesses, this should be the excess applicable. Otherwise, it should contain the highest excess for each business line that differs.
Policy exclusions	49M	If there are any exclusions in the <i>firm's</i> PII

		policy, the business type(s) to which they relate should be entered here.
--	--	---

FSA066 – Capital Adequacy (for *collective portfolio management firms* and *internally managed AIFs*) validations

Internal validations

Data elements are referenced by row, then column.

Validation number	Data element		
1	6B	=	$\Sigma(1B:5B)$
2	12B	=	$\Sigma(7A:11A)$
3	13B	=	$6B - 12B$
4	19B	=	$\Sigma(13B:18B)$
5	20B	=	19B
6	25B	=	$(\text{higher of } 21B \text{ and } 22B) + 23B + 24B$
7	26B	=	$20B - 25B$
8	27B	=	19B
9	31B	=	$27B - (28B + 29B + 30B)$
10	46B	=	$35B - \Sigma(36A:45A)$

External validations

Validation number	Data element		
1	35B	=	FSA030.22A

Capital adequacy - supplemental (for collective portfolio management investment firms)

Higher of:

2 Funds under management requirement

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[illegible]

FSA067 – Capital adequacy – supplemental (for *collective portfolio management investment firms*)

Introduction

The purpose is to provide a framework for the collection of prudential information required by the *FCA* as a basis for its supervision activities. The data item is intended to reflect the underlying prudential requirements contained in *GENPRU* 2.1.63R to 2.1.74R and allows monitoring against the requirements set out there.

Defined Terms

Terms referred to in these notes where defined by the Companies Acts 2006, as appropriate, or the provisions of the *firm's* accounting framework (usually UK GAAP or *IFRS*) bear that meaning for these purposes. The descriptions indicated in these notes are designed simply to repeat, summarise or amplify the relevant statutory or other definitions and terminology without departing from their full meaning or effect.

- The data item should comply with the principles and requirements of the firm's accounting framework, which will generally be UK GAAP (including relevant provisions of the Companies Acts 2006 as appropriate) or *IFRS*.
- The data item should be completed on an unconsolidated basis.
- The data item should be in agreement with the underlying accounting records.
- Accounting policies should be consistent with those adopted in *annual report and accounts* and should be consistently applied.
- Information required should be prepared in accordance with generally accepted accounting standards.
- The data item should not give a misleading impression of the *firm*. A data item is likely to give a misleading impression if a *firm* wrongly omits or includes a material item or presents a material item in the wrong way.

Currency

You should report in the currency of your annual audited accounts i.e. in either Sterling, Euro, US dollars, Canadian dollars, Swedish Kroner, Swiss Francs or Yen. Figures should be reported in 000s.

Data Elements

These are referred to by row first, then by column, so data element 2B will be the element numbered 2 in column B.

Own funds	1A	This amount should be equal to the figure entered in element 57A of FSA003 for the same reporting period.
Funds under management requirement	2A	This is the <i>base capital resources requirement</i> plus the amount which is 0.02% of <i>funds under management</i> that exceeds €250,000,000, up to a maximum of €10,000,000. If the data item is not being submitted with figures specified in Euros, then the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
Fixed overheads requirement	3A	This is the amount calculated in accordance with <i>GENPRU</i> 2.1.53R. The amount should equal element 104A on FSA003 for the same reporting period.
Professional negligence capital requirement	4A	This is the amount of additional <i>own funds</i> used to cover potential liability risks arising from professional negligence in relation to <i>AIFM</i> activities in lieu of professional indemnity insurance, as per <i>GENPRU</i> 2.1.67R(1)(a).

PII capital requirement	5A	This is the amount of any additional <i>own funds</i> required to cover any defined excess in the insurance policy, as required by <i>GENPRU</i> 2.1.67R(1)(b), and any exclusions in the insurance policy that would otherwise result in the <i>firm</i> having insufficient resources to cover liabilities arising, as required by <i>GENPRU</i> 2.1.72R.
Variable capital requirement	6A	This is the amount calculated in accordance with <i>GENPRU</i> 2.1.45R. The amount should equal element 70A on FSA003 for the same reporting period.
Total requirement	7A	This is the higher of 2A and 3A plus 4A or 5A, and 6A.
Surplus / deficit of own funds	8A	This is 1A less 7A.
Liquid assets test		
Liquid assets requirement	9A	This is the amount of <i>own funds</i> required by <i>GENPRU</i> 2.1.64R.
Liquid assets held	10A	This is the amount of liquid assets held by the <i>firm</i> at the reporting date. Assets are regarded as liquid if they are readily convertible to cash within one month. This figure must not include speculative positions.
Surplus / deficit of liquid assets	11A	This is 10A less 9A.
Professional Indemnity Insurance		
Does your firm hold additional own funds or PII in accordance with <i>GENPRU</i> 2.1.67R	12A	The <i>firm</i> should report either “Own funds” or “PII”. Where a <i>firm</i> has PII but also holds <i>own funds</i> to cover any excesses on the policy, the <i>firm</i> should report “PII”.
PII Basic information		
Annualised premium	13A	This should state the premium payable (in descending order of size, where relevant), net of tax and any other add-ons. If the premium covers a period other than 12 months, it should be annualised before ranking.
Insurer (from list)	13B	Select the PII insurer from the list provided. If you have more than one policy with the same insurer, they should be combined. If the insurer is not listed, select ‘Other’. If a policy is underwritten by more than one insurance undertaking or Lloyd's syndicate, you should select ‘multiple’.
Start date	13C	Enter the start date of the policy.
Renewal date	13D	Enter the renewal date of the policy.
Currency of indemnity limits	13E	Using the appropriate International Organization for Standardization ISO 4217 three digit code (e.g. GBP), enter the currency in which the indemnity limits, in fields 13F to 13J are reported.
Limit of indemnity required: single	13F	You should record here the required indemnity limits on the <i>firm</i> ’s PII policy or policies, in relation to single claims. Where these are denominated in a currency other than the currency of the report, the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
Limit of indemnity required: aggregate	13G	You should record here the required indemnity limits on the <i>firm</i> ’s PII policy or policies, in

		aggregate. Where these are denominated in a currency other than the currency of the report, the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
Limit of indemnity received: single	13H	You should record here the indemnity limits on the <i>firm's</i> PII policy or policies, received in relation to single claims. Where these are denominated in a currency other than the currency of the report, the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
Limit of indemnity received: aggregate	13J	You should record here the indemnity limits on the <i>firm's</i> PII policy or policies, received in aggregate. Where these are denominated in a currency other than the currency of the report, the figure should be converted to the currency of the submission using the closing mid-market rate of exchange on the reporting period end date.
<i>PII detailed information</i>		
Business line (from list)	13K	For policies that cover all business lines, <i>firms</i> should select 'All' from the list provided. Where the policy contains different excess for different business lines, <i>firms</i> should identify these business lines from the list (or the closest equivalent) and report the (highest) excess for that business line in data element 13L. Once these 'non-standard' excesses have been identified, the remaining business lines should be reported under 'All other'.
Policy excess	13L	For policies that cover all business lines with no difference in excesses, this should be the excess applicable. Otherwise, it should contain the highest excess for each business line that differs.
Policy exclusions	13M	If there are any exclusions in the <i>firm's</i> PII policy, the business type(s) to which they relate should be entered here.

FSA067 – Capital adequacy – supplemental (for *collective portfolio management investment firms*) validations

Internal validations

Data elements are referenced by row, then column.

Validation number	Data element		
1	7A	=	Higher of ((Higher of 2A and 3A) + 4A + 5A) and 6A
2	8A	=	1A – 7A
3	11A	=	10A – 9A

External validations

Validation number	Data element		
1	1A	=	FSA003.57A
2	3A	=	FSA003.104A
3	6A	=	FSA003.70A

Appendix 2

Designation of Handbook provisions

1. FSA Handbook provisions will be ‘designated’ to create an FCA Handbook and a PRA Handbook on the date that the regulators exercise their legal powers to do so. Please visit our website¹ for further details about this process.

We plan to designate the Handbook Provisions which we are proposing to create and/or amend within this Consultation Paper as follows:

FUND

Handbook Provision	Designation
All provisions in the Investment Funds sourcebook (FUND)	FCA

Glossary Provisions – new definitions

Handbook Provision	Designation
All new definitions	FCA

Glossary Provisions – existing definitions

Handbook Provision	Designation
Existing definitions	FCA and PRA

¹ <http://media.fsahandbook.info/latestNews/One-minute%20guide.pdf>

SYSC

Handbook Provision	Designation
SYSC 4.1.1	FCA and PRA
SYSC 4.1.1A	FCA
SYSC 4.1.2	FCA and PRA
SYSC 4.1.2B	FCA
SYSC 4.1.2C	FCA
SYSC 4.1.2D	FCA
SYSC 4.2.1	FCA and PRA
SYSC 4.2.2	FCA and PRA
SYSC 4.2.4	FCA and PRA
SYSC 4.2.5	FCA and PRA
SYSC 4.2.7	FCA
SYSC 4.2.8	FCA
SYSC 4.2.9	FCA
SYSC 6.1.4 -A	FCA and PRA
SYSC 7.1.7B	FCA and PRA
SYSC 10.1.1	FCA and PRA
SYSC 10.1.22	FCA
SYSC 10.1.23	FCA
SYSC 10.1.24	FCA
SYSC 10.1.25	FCA
SYSC 10.1.26	FCA
SYSC 19A.1.1A	FCA
SYSC 19B (whole chapter)	FCA

GENPRU

Handbook Provision	Designation
GENPRU 1.2.11	FCA and PRA
GENPRU 2.1.8	FCA and PRA
GENPRU 2.1.45	FCA and PRA
GENPRU 2.1.46	FCA

GENPRU 2.1.48	FCA and PRA
GENPRU 2.1.63	FCA
GENPRU 2.1.64	FCA
GENPRU 2.1.65	FCA
GENPRU 2.1.66	FCA
GENPRU 2.1.67	FCA
GENPRU 2.1.68	FCA
GENPRU 2.1.69	FCA
GENPRU 2.1.70	FCA
GENPRU 2.1.71	FCA
GENPRU 2.1.72	FCA
GENPRU 2.1.73	FCA
GENPRU 2.1.74	FCA

BIPRU

Handbook Provision	Designation
BIPRU 1.1.3	FCA and PRA
BIPRU 1.1.8	FCA and PRA
BIPRU 1.1.18	FCA and PRA
BIPRU 1.1.19	FCA and PRA
BIPRU 1.1.20	FCA and PRA
BIPRU 1.1.21	FCA and PRA
BIPRU 8.5.7	FCA and PRA
BIPRU 8.5.8	FCA and PRA

IPRU(INV)

Handbook Provision	Designation
IPRU(INV) 5.2.3	FCA
Chapter 7 (whole chapter)	FCA

COBS

Handbook Provision	Designation
COBS 2.1.1	FCA
COBS 2.1.4	FCA

SUP

Handbook Provision	Designation
SUP 16.12.4	FCA and PRA
SUP 16.12.11	FCA and PRA
SUP 16.12.12	FCA and PRA
SUP 16.12.13	FCA and PRA
SUP 16.12.15	FCA
SUP 16.12.16	FCA and PRA
SUP 16.12.17	FCA and PRA
SUP 16.12.19A	FCA
SUP 16.12.20	FCA
SUP 16.12.21	FCA
SUP 16.12.22A	FCA and PRA
SUP 16.12.23	FCA and PRA
SUP 16.12.24	FCA and PRA
SUP 16.12.25A	FCA and PRA
SUP 16.12.26	FCA and PRA
SUP 16.12.27	FCA and PRA
SUP 16 Annex 24	FCA and PRA
SUP 16 Annex 25	FCA and PRA

PUB REF: 003031

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