HM TREASURY

Policy options for implementing the Alternative Investment Fund Managers Directive

March 2012

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ISBN 978-1-84532-941-9
PU1262

Subject of this consultation	The transposition of the Alternative Investment Fund Managers Directive in the United Kingdom.
Scope of this consultation	This is an informal discussion paper highlighting and inviting initial views on a number of the high level policy decisions that will need to be taken as part of the transposition of the Alternative Investment Fund Managers Directive in the United Kingdom.
Who should read this	HM Treasury would like to hear from UK-based fund managers that deem at least part of their regular business as managing AIFs (including UCITS management companies if they manage AIFs as well), discretionary investment managers, operators of unregulated collective investment schemes, investment companies that do not employ an external fund manager, depositaries and custodians holding the assets of AIFs, prime brokerage facilities, investors, trade bodies, and others interested in the Directive and its transposition.
Duration	The consultation will run from 14 March 2012 to 4 May 2012.
Enquiries	For general enquiries regarding this discussion paper, please contact Sameen Farouk at HM Treasury on 020 7270 6038, or sameen.farouk@hmtreasury.gsi.gov.uk.
How to respond	Please send responses to: AIFMD Transposition Financial Regulation and Markets HM Treasury 1 Horse Guards Road SW1A 2HQ E-mail: aifmd@hmtreasury.gsi.gov.uk
Additional ways to be involved	Please indicate whether you are willing to discuss these issues with HM Treasury. HM Treasury will consider meeting interested parties to discuss issues raised in this discussion paper. The timing, format and venue of these meetings will be informed by expressions of interest received.
After the consultation	Responses will help inform a policy position for a formal consultation at a later date. The intention is to publish a formal consultation in the Summer 2012.
Getting to this stage	HM Treasury has carried out an initial analysis of high level options for transposition and consulted informally with interested parties.

Contents

1 Introduction

1.1 The Alternative Investment Fund Managers Directive[1] (AIFMD) was adopted by the European Parliament and Council on 8 June 2011. The Directive is due to be transposed into national law by 22 July 2013.

1.2 The Directive establishes an EU-wide harmonised framework for monitoring and supervising risks posed by Alternative Investment Fund Managers (AIFMs) and the funds they manage (AIFs); and for strengthening the internal market in alternative investment funds. The Directive requires the authorisation of AIFMs. There are provisions relating to how AIFMs conduct their business, transparency and marketing. The Directive covers the investment managers of hedge funds, private equity funds and real estate funds among others and is therefore relevant to many different types of asset manager.

1.3 The Directive provides for an extensive set of implementing measures. Following advice provided by the European Securities and Markets Authority, the Commission is currently developing such measures and it is anticipated these will be proposed shortly. The measures will then be adopted using the EU's legislative procedures for delegated and implementing acts; these are expected in summer 2012.

1.4 Transposition into UK law will require a number of high-level policy decisions, as well as a considerable number of operational ones. The Financial Services Authority has published a discussion paper covering operational issues[2] and the Treasury paper highlights some of the key high-level issues that will need consideration. To ensure consistency, the abbreviations and terms in the FSA paper are used in this paper. The areas covered by this paper are:

- Requirements for AIFs falling below the Directive's threshold for full authorisation
- Interaction with proposed Regulations on Venture Capital and Social Entrepreneurship Funds
- Application of the approved persons regime[3]
- The extent to which AIFs should be marketed to retail investors
- Private placement regime

1.5 The Government has set out its overall approach to transposing EU legislation, with the expectation that a "copy-out" approach will be adopted wherever possible in order to minimise the regulatory burden on firms. Consideration of the questions raised in this paper will be consistent with this; strong justification will be required for proposed additional measures which exceed the terms of EU legislation ("gold-plating")[4]. When making its assessment, the Government will be considering UK competitiveness, costs to consumers, consumer protection

[1] Directive 2011/61/EU on Alternative Investment Fund Managers

[2] DP12/1 Implementation of the Alternative Investment Fund Managers Directive, January 2012

[3] Statements of Principle and Code of Practice for Approved Persons.

[4] The Government's principles for introducing European measures into UK law may be found at http://www.bis.gov.uk/policies/bre/policy/european-legislation/goldplating

and confidence in the regulatory system, and welcomes views from market participants and consumers.

1.6 The Treasury and FSA discussion papers are an important early step in engaging with interested parties to set out the UK Authorities' initial thoughts, and to begin identifying possible impacts, and concerns.

1.7 Following the conclusion of the period of these discussion papers, draft legislation will be prepared and this will be the subject of a formal consultation which will take place in autumn 2012.

1.8 The Government has announced that the FSA will be replaced by two separate and distinct prudential and conduct regulators by mid-2013. These are the Prudential Regulatory Authority (PRA) for the prudential regulation of deposit takers, insurers and other systemic financial firms whose business activities require a significant degree of expert prudential supervision and the Financial Conduct Authority (FCA) for conduct regulation of all firms and prudential regulation of all non-PRA regulated firms. For simplicity, this paper refers to the FSA throughout but the working assumption to date is that the FCA will be the competent authority for most, if not all, AIFMs falling within the scope of the Directive's provisions.

2 Transposition issues

Requirements for sub-threshold AIFMs

2.1 The Directive requires AIFMs to be authorised but permits Member States to establish a *de minimis* registration regime for AIFMs managing AIFs with assets under management below certain thresholds[1]. Member states have the option, however, of imposing additional requirements. The Government will need to decide the categories of small AIFMs for which it exercises this option and, where it is exercised, the extent to which additional requirements should be applied.

2.2 Under current UK regulation, a wide range of small AIFMs are already FSA-authorised for regulated activities such as operating a collective investment scheme (CIS), or discretionary portfolio management. Examples include managers of Non-UCITS Retail Schemes (NURS), Qualified Investor Schemes (QIS), and Unregulated Collective Investment Schemes (UCIS) – including many hedge funds.

2.3 The range of options open to the Government for smaller AIFMs include the following:

1 Full application of AIFMD requirements to all smaller AIFMs

2 Apply a lighter regime selectively, differentiating between AIFMs

2.4 Smaller AIFMs subject to the sub-threshold regime may not benefit from the Directive's marketing and management passports. However, they have the right to opt-in to full authorisation in order to benefit from these passports.

Option 1 – Full application of Directive requirements to all smaller AIFMs

2.5 The Government has the option of fully applying all requirements of the Directive to all small AIFMs. These requirements are explained in more detail in the FSA's Discussion Paper, but in brief would include the following requirements:

1 AIFMs must be authorised by the FSA. This is a more stringent process than registration, as the FSA authorisation process assesses a firm's and individual's ability to satisfy the minimum conditions in order to become admitted to the financial services regulatory system. The FSA has more powers over authorised persons than over registered persons, including on-going supervision, powers to make rules over authorised persons and to discipline them.

2 The Directive imposes, for example, obligations on AIFMs in relation to remuneration policies; conflicts of interest; risk management (including the requirement to set a maximum level of leverage); liquidity management, and annual valuation of assets.

3 There are restrictions on the AIFM's ability to delegate tasks.

[1] Article 3(2)-(4) provides that Member States may apply a less stringent regulatory regime with opt-in procedures such that smaller AIFMs may benefit from the EU AIF management and/or marketing passport under Chapter VI of the Directive. See also Section III of the Final Report on ESMA's technical advice to the European Commission on possible implementing measures of the AIFMD, 16 November 2011.

4 The AIFM must appoint a depositary to monitor cashflows, and to safeguard assets. Various obligations are placed on the depositary directly, and the depositary is subject to potentially onerous liability provisions.

5 The AIFM must produce an annual report and make certain disclosures to investors. The AIFM must also report regularly to the FSA about the principal markets and instruments in which it trades, and about the assets of the AIFs it manages, consisting of information about their principal exposures and important concentrations, liquidity, leverage, and risk management including the results of portfolio stress tests.

6 The FSA must use the information reported to it to monitor systemic risk, and pass on the information to other Member States, ESMA and ESRB. The FSA has power to impose limits on the use of leverage where necessary to ensure stability and integrity of the financial system.

7 In the case of an AIF which acquires control of a non-listed company, for example a private equity fund, there are obligations on the AIFM to provide certain information to the FSA, portfolio companies, and shareholders and employees of portfolio companies. There are also obligations on the AIFM not to engage in asset-stripping.

2.6 The FSA has indicated that, in practice, it would apply Directive requirements in a proportionate way to smaller AIFM according to the regulatory risks that these might present.

2.7 Under option 1, small AIFMs newly subject to FSA regulation would be subject to the full requirements of the Directive. The greatest impact would be on the managers of a small number of UK-domiciled funds that neither fall within the current UK definition of Collective Investment Scheme, nor are subject to Listing Rules and the requirements of the Prospectus Directive.

2.8 Option 1 would also represent a significant increase in regulation for companies subject to the requirements of the Prospectus Directive and the Listing Rules but which fall outside the current UK definition of Collective Investment Scheme. In practice this includes UK-domiciled Investment trusts and Venture capital trusts.

2.9 AIFMs already subject to FSA authorisation would be subject to a limited number of additional obligations. For example, the depositary, use of leverage by AIFMs and private equity provisions are new.

2.10 This option goes well beyond the minimum requirements of the Directive and depending on how the FSA implements a proportionate regime could represent significant gold plating. Strong justification would be needed to apply the Directive's full requirements to all smaller AIFMs. An argument in favour of this option is that it avoids the development of a two-tier regulatory regime for AIFMs, which carries the risk of investors making decisions to subscribe to AIFs on the basis of false perceptions about the regulatory protections from which they might benefit. It also minimises the potential for regulatory risks to crystallise that might have adverse consequences for confidence in the regulatory system.

2.11 However, there are potential drawbacks with this approach in that it would impose the costs of full authorisation on all AIFMs, irrespective of other safeguards, for example, for small investment trusts already subject to the Listing Rules and the Prospectus Directive, and irrespective of to whom the funds are marketed. Professional investors could be expected to understand better than retail investors the nature and extent of the regulation applied to AIFMs, but no account would be taken of this.

Box 2.A: Questions 1 to 4

To what extent would a consistent approach of full application of Directive requirements across different types of AIFM benefit AIFMs, AIFs and investors in terms of investor understanding and reputation of the UK's financial services regulatory regime?

What would the impact be on the different types of AIFMs, AIFs and investors – including those that would be subject to greater regulation than at present? What are the likely costs and benefits?

What would be the likely impact on the AIF market of requiring full authorisation of all small AIFMs?

What other impact would this option have on different kinds of AIFs, AIFM, and on investors?

Option 2 – apply a lighter regime selectively, differentiating between AIFM

2.12 The Government may choose to apply a lighter regime selectively to some small AIFMs. Depending on the type of small AIFM, it could be subject to registration only, selective application of authorisation requirements, or full Directive authorisation. Differentiation between different types of AIFM would be based on objective criteria.

2.13 A regime most closely resembling the status quo would involve:

1 Retaining FSA authorisation for small AIFMs managing CIS including QIS, NURS and UCIS, with minimal new Directive requirements applied;

2 Retaining FSA authorisation (with minimal new Directive requirements applied) for small external AIFMs of non-CIS funds i.e. those managing Investment trusts and VCTs, together with those hedge funds, private equity firms and other types of fund that are structured as investment companies; and

3 Applying a limited registration-only regime to internally managed non-CIS funds with assets below the Directive's thresholds.

2.14 There is a considerable range of variants to this approach. For AIFMs that are already authorised, this could include:

1 Applying some of the new Directive requirements selectively where these are considered to bring in appropriate levels of investor protection;

2 Differentiating between AIFMs that are currently authorised, for example on the basis of applying a lighter regime for external AIFMs of non-CIS funds, or a heavier regime for AIFMs of retail funds;

2.15 For AIFMs not currently authorised, this could include applying the Directive requirements selectively, e.g. applying the leverage requirements to internally-managed non-CIS funds that routinely use leverage.

2.16 If the Government were to introduce a registration regime for small AIFMs, there could potentially be an anomalous outcome whereby an external entity appointed as the AIFM of a sub-threshold AIF would be subject to registration, whereas an external entity appointed as the MiFID delegate of that AIF – and therefore responsible for a narrower range of tasks – would require authorisation.

2.17 This option also risks creating a two-tier regulatory regime for AIFMs – with the associated uncertainties for investors – and reduces the FSA's power to act where AIFMs aren't authorised. They key advantage is that it provides maximum scope to balance investor protection with flexibility and minimising the regulatory cost to AIFMs that goes beyond the proportionate approach to authorisation that would be taken by the FSA in any case.

Box 2.B: Questions 5 to 8

What objective criteria should the Government use to differentiate between different regimes for small AIFMs?

- Should there be differentiation based upon AIF investment strategy, type of AIFM, type of AIF or type of investor?
- What would the justification be for the differentiation?

What should each regime entail and why? Which Directive requirements in particular should be applied or disapplied to each group?

What would be the costs and benefits of each regime for different kinds of AIFs, AIFMs, and investors?

The Government welcomes views on the regulatory anomaly referred to in 2.16.

2.18 The Government could potentially apply the sub-threshold exemption in full – all small AIFMs would be subject only to the *de minimis* AIFMD registration regime. In practice this would entail registration with the FSA and the requirement to make certain disclosures to the FSA identifying the AIFM, the AIFs it manages and to provide sufficient information for the FSA to monitor systemic risk. For AIFMs not currently regulated by the FSA it would represent the minimum increase in regulation required by the Directive, and for AIFMs currently authorised, it would represent a substantial reduction in regulation.

2.19 This approach would be consistent with the Government's deregulatory agenda and "copy-out" approach to EU legislation, allowing AIFMs flexibility in their management of funds and imposing the lowest increase in costs. In most instances, costs would be reduced. However, set against this is the considerable and indiscriminate reduction in UK investor protection, including for funds marketed to retail investors. For example, the requirement to avoid conflicts of interest would not be applied. There is the potential for this to damage perception of the efficacy of the regulatory regime and lead to the detriment of retail investors. The Government is therefore minded to apply a more selective approach.

Box 2.C: Question 9

Your views are welcome on how/whether an appropriate investor protection regime should be maintained, in particular for retail investors. If the Government decides not to apply the full AIFM requirements to all small AIFMs, should it apply a lighter regime selectively rather than the *de minimis* AIFMD registration regime to all small AIFMs?

Proposed Regulations on Venture Capital Funds and European Social Entrepreneurship Funds

2.20 The Commission has proposed Regulations on European Venture Capital funds[2] and European Social Entrepreneurship Funds[3] under which managers of certain sub-threshold AIFs would be entitled to market to professional investors (and certain non-professionals) in the EU upon compliance with the Regulation provisions. The requirements imposed under the proposed Regulations are considerably lighter than the full Directive requirements, but go further than the Directive minimum registration regime

Box 2.D: Question 10

The proposed Regulations have not yet been adopted, and their provisions are subject to change. However, if possible, it would be helpful to receive views on the extent to which venture capital funds, and social investment funds, are likely to benefit from the proposed Regulations.

Approved persons regime

2.21 Within the UK, the FSA applies an "approved persons" regime[4] to individuals carrying out "controlled functions" within authorised firms, including fund managers. These are typically individuals who have a significant influence over the operations of the firm (for example the CEO or managing partner) or are performing key roles, such as compliance, audit, and risk management or dealing with customers.

2.22 The approved persons regime gives the FSA the right to vet the fitness and propriety of key individuals, and apply appropriate sanctions if they breach the FSA's rules or principles. There are also requirements around training and competence for certain functions carried on for retail clients.

2.23 The approved persons regime is a UK concept under the Financial Services and Markets Act 2000 and is not required under the Directive.[5] The UK is permitted, but not compelled, to apply the regime. The Government may therefore decide whether or not to apply the regime to individuals within AIFMs newly subject to regulation. These include, for example, internally managed listed investment funds. The FSA has indicated that if the regime is applied, it would exercise its powers in a proportionate manner.

2.24 Applying the approved persons regime would give the FSA the opportunity to vet the suitability of an individual to perform important functions. Furthermore, because the regime covers individuals rather than the firm, it would allow the FSA to take a nuanced proportionate approach, taking action against individuals rather than the firm.

2.25 However, directors of companies are already subject to company law requirements and in many cases, the Listing Rules, which impose corporate governance requirements. It could be argued that, given the existing degree of regulation, application of the approved persons regime in addition would be regarded as unnecessary gold-plating. While consistent with the approach taken for other AIFMs, it could also be inconsistent with the approach taken to AIFs passported

[2] Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds (December 2011): http://ec.europa.eu/internal_market/investment/docs/venture_capital/111207-proposal_en.pdf

[3] Proposal for a Regulation of the European Parliament and of the Council on European Social Entrepreneurship Funds (December 2011): http://ec.europa.eu/internal_market/investment/docs/social_investment/20111207proposal_en.pdf

[4] See Statements of Principle and Code of Practice of Approved Persons Regime (APER)

[5] See Recital 22 of AIFMD

into the UK from other Member States under the Directive, since it cannot be assumed that a comparable regime would be applied in those States.

Box 2.E: Questions 11 and 12

What are the costs and benefits of applying the approved persons regime to internally managed non-CIS companies? Do you consider the approved persons regime should be disapplied in the case of such companies?

Non-CIS companies listed on the Official List are subject to the additional protection of Listing Rules. Do you believe they should be treated differently in terms of application of the approved persons regime to unlisted companies? What would be the costs and benefits of this?

Marketing to retail

2.26 By default, the Directive prohibits the marketing of AIFs to retail investors but gives Member States the discretion to permit marketing selectively and impose greater restrictions than those for marketing to professional investors.

2.27 Under the current UK regime, there are two types of UK fund within the scope of the Directive that that may be marketed to retail:

1 **Collective Investment Schemes that are authorised by the FSA as Non-UCITS Retail Schemes (NURS)[6].** The FSA has a number of detailed rules applicable to NURS, including rules that restrict what NURS may invest in; rules that impose maximum limits on certain kinds of investments; and rules that restrict borrowing by NURS.

2 **Companies are exempted from the CIS regime but are subject to the general rules of company law.** In practice, this includes Investment Companies. If such companies wish to market their shares to the public, they must produce a prospectus which is approved by the FSA and is compliant with the Prospectus Directive[7]. Non-CIS companies which are subject to the listing rules (a category which includes investment trusts and venture capital trusts) are also subject to substantive regulation imposed by the listing rules.

2.28 CIS that are "recognised schemes" under sections 270 and 272 FSMA, namely schemes from outside the UK which have been recognised as providing comparable protection to NURS, may also be marketed to retail investors in the UK.

2.29 Transposition of the Directive provides the opportunity to extend or restrict the range of schemes permissible as being marketed to retail investors. Any extension of the retail boundary may well require significant extra regulation before the additional schemes became suitable for retail investors.

[6] The sale or transfer of units in a Qualified Investor Scheme is restricted to specified categories of eligible investors, some of whom would not automatically be professional investors under AIFMD and MiFID.

7 The exception to this rule is when the company's share offering is less than 5 million.

Box 2.F: Question 13 to 15

Do you agree that the UK should retain its current restrictions on the types of domestic fund that may be marketed to retail investors? If you do not agree, which additional funds should be permitted to be marketed to retail investors and why?

What additional restrictions should they be subject to?

What would be the costs and benefits?

Private placement regime

2.30 The Directive permits member states to continue national private placement for at least the first five years of the application of the Directive. It requires that third country (i.e. non-EU) managers of third country AIFs that wish to market their funds in a Member State must comply with the Directive's provisions on transparency and (if applicable) the rules on private equity disclosure.

2.31 The Government may opt to apply additional Directive requirements for national private placement in the UK. In order to ensure continued investor access to third country AIFs, the Government is minded not to impose additional requirements for third country managers of third country funds above the Directive minimum.

Box 2.G: Questions 16 and 17

Do you agree that the Government should not impose additional private placement requirements for third country managers of third country funds?

If you believe the Government should impose additional requirements, what should they be and why? What would be the costs and benefits of imposing additional requirements?

3 The engagement process

How to respond

3.1 This document describes some of the broad issues regarding transposition of the AIFMD into UK law. Responses to the discussion paper should be sent by 4 May 2012.

By email to aifmd@hmtreasury.gsi.gov.uk

By post to AIFMD Transposition, Financial Regulation and Markets, HM Government, 1 Horse Guards Road, London SW1A 2HQ

Please be aware that all responses may be shared with the Financial Services Authority.

3.2 All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

3.3 When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people or businesses you represent.

Confidentiality

3.4 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

3.5 If you want the information that you provide to be treated as confidential, please be aware that, under FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Government or the Financial Services Authority.

3.6 HM Government and the Financial Services Authority will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

HM Treasury contacts

This document can be found in full on our website: http://www.hm-treasury.gov.uk

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ISBN 978-1-84532-941-9