27 March 2012

Investment Funds Team
Conduct Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

By email: dp12_01@fsa.gov.uk

Dear Sirs,

Re: BVCA Regulatory Committee response to FSA Discussion Paper on Implementation of the Alternative Investment Fund Managers Directive (DP 12/1)

This response to the FSA discussion paper on the implementation of the Alternative Investment Fund Manager's Directive (DP 12/1) is made by the British Private Equity and Venture Capital Association ("BVCA").

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. The BVCA Membership comprises over 250 private equity, midmarket and venture capital firms with an accumulated total of approximately £32 billion funds under management; as well as over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include real estate funds, international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

In our response, our points are generally made in reference to private equity but could equally apply to other investment strategies incorporated by BVCA members, notably venture capital and real estate investment. In order to focus our response appropriately we have considered only those parts of the Discussion Paper which we think raise issues relevant to private equity and venture capital firms.

We welcome the FSA's engagement with industry in seeking to achieve the aims of the Directive. We have aimed to provide constructive responses to the questions in the Discussion Paper and we look forward to working with the FSA throughout the implementation process.

British Private Equity & Venture Capital Association
1st Floor North, Brettenham House, Lancaster Place, London WC2E 7EN
T +44 (0)20 7420 1800 F +44 (0)20 7420 1801 bvca@bvca.co.uk www.bvca.co.uk

Yours faithfully

Margaret Chamberlain
Chair - BVCA Regulatory Committee

FSA DISCUSSION PAPER 12/1 - IMPLEMENTATION OF THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

Q1. What other criteria could be used to distinguish a JV from an AIF and, in particular, a JV where not all participants are involved in its day-to-day management?

The exact characteristics of a joint venture will vary with the subject matter of the venture. It is therefore not possible to list a number of factors which must be present for there to be a joint venture, at best there could only be a list of factors which might be relevant, but the absence of which would not be determinative. For example, in some types of joint venture each participant in the joint venture undertaking will have a right to participate in the key strategic decisions relating to the undertaking. AIF investors do not generally expect to retain active involvement in decisions about the management of the AIF, whereas it is can be very important to joint venture participants to be involved in key strategic decisions.

However we consider that the private, bespoke, negotiated nature of a joint venture arrangement means that the concept of "raising capital from a number of investors with a view to investing it in accordance with a defined investment policy" is simply not applicable, the joint venture arrangement is not a fund raising activity, it is a vehicle for carrying out the joint venture .

Q4.

(a) Which aspects of the Directive should we consider applying to small UK AIFMs?

(b) In particular, which aspects of the Directive should we consider applying given that a distinction may be drawn between types of AIF or AIFM?

Our general view is that as few as possible of the provisions of the Directive should apply to small UK AIFMs which meet the threshold/size exemptions. The Directive does not mandate that any of its provisions automatically apply to small AIFMs, unless they decide to "opt in" in order to use the passport. Small AIFMs tend to manage venture and growth funds, making early stage investments, and it is critical that these AIFM are not discouraged from being based in the UK, and if the UK imposes additional rules on small AIFMs which are not also imposed by other Member States, then the UK will not be seen as an attractive base for such firms. The Directive allows for a registration regime and we believe that this is the option which should be explored. We note that those firms who would qualify to be a "small AIFMs" will potentially fall within the ambit of the proposed European Commission Directive on European Venture Capital Funds and there is nothing in the draft of that directive which requires full regulation (as opposed to registration). The UK should not impose a regime on small AIFMs which is not required either under the AIFMD or under the proposed Venture Capital Regulation.

If a small AIFM only conducts the proposed regulated activity of "managing AIFs" then we strongly support a registration regime only, which would disapply all or the vast majority of the provisions of the Directive (including regulatory capital and remuneration provisions) and we would also suggest that the FSA should disapply the majority of the current rules which impact upon those firms. We note that one of the policy options set out in the HM Treasury Paper (Policy options for implementing the Alternative Investment Fund Managers Directive) is a registration regime for small AIFM and we believe there are good reasons for supporting such a position provided such AIFM do not market their funds to retail investors. We believe that this provides an appropriate balance between investor protection, flexibility and appropriate regulatory obligations for such firms.

In particular small firms (particularly those in the venture capital/private equity market) do not pose systemic risk issues and it is important that the UK approach is proportionate and not unduly burdensome on new entrants to the market.

We note that there is a proposal to introduce a specific regulated activity of "managing AIFs". We assume this will be required to perform the activities in paragraph 1 of Annex 1 as an in-scope AIFM and that a small AIFM which is out of scope will not need this permission.

Q5. What factors should be considered when assessing the fair treatment of consumers, especially where some investors in a fund have received preferential treatment?

We agree that "fair treatment" is a subjective test and cannot be judged on a static set of criteria. Given the range of AIF covered by the Directive it would be an impossible and fruitless task to try to define a harmonised set of criteria for assessing fairness.

Investors in private equity funds are typically large, sophisticated institutions which fall within the classification for per se professional clients. Commonly they invest in a number of private equity funds and often invest in consecutive funds with the same firm.

It is important in this context to have a clear view of what is meant by "preferential treatment" of an investor. As has already been accepted, if an investor is prepared to make an earlier commitment or a more significant investment than other investors, then it is not 'preferential' if it is in some way treated differently as the consideration for its obligations.
It is overly simplistic to assume that offering co-investment opportunities to investors necessarily implies preferential treatment. Whilst this is commonly an option that is raised at the pre-commitment stage with all investors, it is not an option that is suitable for all investors. Once the pool of investors who are interested is settled then it is for them to agree with the manager the basis on which the issue is dealt with.

In our view the principal factor to consider in assessing fairness in the professional market is the adequacy and timeliness of the disclosure of the nature of any preferential treatment.

Q6. Do you agree that fair treatment of retail consumers should equally apply to professional investors?

We strongly disagree with this proposal. Retail investors have different needs and expectations from those of professional investors. As noted in our response to Q5 above, investors in private equity funds tend to be per se professional investors. Applying concepts and rules devised for the protection of retail investors is not appropriate for sophisticated professional investors investing in AIF. As we have previously noted, in private equity AIF the investors negotiate their terms of investment and impose requirements on the AIFM, the balance of power is not all one way as it may be in the general retail market.

See also our response to Q5 above.

Q7. What organisational arrangements might raise particular issues for UK AIFMs? Do these requirements pose particular difficulties for private equity firms in the light of their distinct business model?

IOSCO has already considered at length the issues concerning conflicts of interest in private equity firms and we generally agree with their conclusions on this issue.

We have explored issues relating to risk management and separation of functions for private equity firms in our response to Q13 below.

Q8. What are the major challenges in the development of remuneration guidelines appropriate to the structure of AIFMs?

It is critical that ESMA should develop guidelines under Article 13(2) which include tailoring to reflect venture capital/private equity incentive models. We note that:

- The remuneration aspects of CRD3 were tailored to the pay practices used by banks and investment banks. The Committee of European Banking Supervisors ("CEBS") deliberately did not deal with PE/VC models in its guidelines. Although the BVCA met at the time with CEBS (who understood that the PE/VC model was entirely consistent with the policy objective) CEBS did not need to consider the issues in detail because it was able to disapply key aspects of CRD3 on the basis of proportionality. For that reason, the CEBS guidelines are an inappropriate basis for drafting the ESMA guidelines.

- The CRD3 provisions were copied into Annex II to AIFMD at a very late stage of the Level 1 legislative process. The few adaptations that were made reflected best practice in relation to the incentives offered to hedge fund managers and managers of other open-ended AIF.

For these reasons, there will be considerable work to do in developing the ESMA guidelines if they are to be fit for purpose.

Typical PE/VC incentive models feature inherent long-term deferral and risk adjustment characteristics, as well as distributions based only on realised (not accounting) profits to investors. There is therefore an obvious and strong policy argument that carried interest and co-investment schemes satisfy policy requirements for deferral, participation alongside investors, and performance adjustment.

The challenge is therefore to align the drafting of Annex II with the policy, and the policy with existing models. Key concerns are as follows:

- Annex II assumes that important incentive awards take place on an annual basis. In fact, carried interest awards are generally made only on establishment of a new closed-ended AIF. Each AIF might have a life of ten or more years. An AIFM might run two active funds in parallel, so a particular executive might acquire carried interest units only about once every five years.

- Annex II assumes that elements of incentive will have a substantial value on award, which is readily measurable. Whilst carried interest is critically important to PE/VC executives and is, in many cases, the most significant aspect of their incentive, it "blossoms" over time and may not have any measurable value in the performance year of award or indeed in any performance year prior to the realised profit being returned to investors. There would, therefore, be fundamental difficulties in applying the requirements as they are drafted, for 40% deferral (paragraph 1(n)) and 50% payment in units (paragraph 1(m)).

Our proposed solutions to these key problems would be for ESMA to take a purposive approach in the draft guidelines:

- ideally, by recognising that one effect of the requirement in Annex II that the listed principles apply "to the extent...appropriate" to the firm's arrangements is that provided that alternative arrangements exist which satisfy the policy objectives (and those arrangements could be specified by ESMA), certain of the listed principles do not apply;

- failing that, by taking a purposive approach and acknowledging that typical PE/VC incentives satisfy the listed principles;

- failing that, by working with us to agree some alternative measure of the value of carried interest awards exclusively for regulatory purposes (and not for the purposes of property or tax laws). We are considering what alternative measures exist and how they might be employed.

Q9. What options could be considered for implementing the remuneration requirements of the Directive that would achieve fair and appropriate alignment with the existing Remuneration Code?

For the reasons set out in response to Q8 above, the current tiering approach to proportionality (including disapplication of certain rules) would be one good way of reflecting a proportionate approach to application of the Directive's requirements. Unless that can be achieved through amending the current Code, it is likely to be preferable to develop a separate set of rules.

It is important that when implementing the requirements there should not be any attempt to "gold plate" the terms of the AIFM Directive by applying CRD3 requirements which go further than the requirements of the AIFM Directive.

Q10. What are the practical issues for potential AIFMs in establishing a remuneration committee?

We do not believe that any UK venture capital/private equity firm should be regarded as significant in terms of its headcount, AUM, internal organisation or complexity. In addition the role of such a committee would be limited as (typically) the most important part of an executive's incentive is through the carried interest arrangements, which are agreed with investors in advance and are linked to the fund performance. Were they required to maintain a remuneration committee the key difficulty would be to accommodate an independent committee in a privately owned group of management companies. The senior managers of venture capital/ private equity groups are typically their partner co-owners. We suggest that only the largest multi-strategy investment management groups should be required to have an independent remuneration committee. Those largest groups are likely to be publicly traded groups which already have non-executive directors capable of fulfilling the relevant functions.

Q11. What criteria should be used to determine whether it is disproportionate to require an AIFM to have a separate compliance function? What criteria should be used to determine whether it is disproportionate for an AIFM to establish an audit function?

We support the approach that the need for a separate compliance function and audit function should be judged on the size, nature, scale and complexity of an AIFM's business. The following criteria are not intended to be an exhaustive list and we expect that the FSA will continue to enforce the

proportionality principles in the way it does under current rules – understanding that the compliance demands of regulated firms cannot be ascertained on the basis of an objective list of criteria. Rather a subjective understanding of the complexities and workings of an AIFM's business must be taken into account when considering what is proportionate for a particular firm.

The FSA should also bear in mind that some AIFM may benefit from having a compliance officer who is also involved in the business of the firm as this permits them a greater insight of the potential risk and compliance issues that the AIFM may face.

Subject to this approach, when considering whether an AIFM requires a separate compliance function the following criteria should be taken into account:

- head count of the firm;
- volume of transactions;
- the business model;
- number of investors;
- whether the fund accepts retail as well as professional investors;
- the product types available;
- the AIFM's jurisdiction;
- the AIFM's permissions (and in particular whether the firm is permitted to hold client money).

In relation to the audit function it is likely that an AIFM will need an independent compliance function before it needs an audit function. The two functions cover distinct areas and will not be needed under the same circumstances. An audit function is more commonly required for firms with more complex operations.

Q12. As organisational requirements are also covered by other Directives relevant to fund management, such as MiFID and the UCITS Directive, will any potential overlap with these Directives create any problems?

It is vital that in implementing the provisions of the Directive the FSA adopts a common approach with the existing body of legislation governing the practices of all financial services providers and, in particular, applies the principles of proportionality in common with its existing practices.

Q13. In what circumstances would you be unable to meet the requirement to have functional and hierarchical separation of your risk management function and would need to rely on having appropriate safeguards?

It is important to appreciate the different risk management strategies employed by different types of AIFM. In relation to venture capital/private equity firms, risk management takes place as part of

the investment due diligence process. This is in contrast to other types of AIF (e.g. hedge funds) where the risk management may be entirely divorced from investment management. The risk controls available in the hedge fund sphere are not applicable for venture capital/private equity firms. For example, venture capital/private equity firms cannot "hedge" one investment against another in the same way that hedge funds can.

Before any investment is made venture capital/private equity firms spend considerable time looking at the potential risks of a proposed investment. A number of potential investments are disregarded at a very early stage. For those which the private equity house does not initially disregard, professional advisers including lawyers, tax specialists and accountants are engaged in order to fully review all aspects of the business. The reports from the professional advisers are considered internally together with an assessment on the potential return for investors.

In light of this, it would not be possible to separate the investment process and the risk management functions. To do so would undermine the AIFM's ability to judge the potential return of an investment and this would, in turn, increase risk to investors. Investors are attracted to the private equity model partly because of the investment process and the close attention that executives pay to investment risk issues.

ESMA proposes that appropriate safeguards should also meet an independence test in its Final Report in boxes 26 and 30. The alternative option for reliance on such safeguards does not, therefore, resolve the potential difficulty some firms will face in meeting the risk management requirements. Firms should be able to rely on having appropriate safeguards, but those safeguards should not only be available by meeting an independence test.

Q14. For what reasons might the use of a qualitative, not a quantitative, risk limit, be in the interests of AIF investors?

There is a significant variety of different AIFs that will be subject to the terms of the Directive. As such, it is important that AIF are permitted the flexibility to employ such risk limits (whether qualitative or quantitative) as is most appropriate for the operation of their particular AIF type.

Q15. What constitutes a 'material change' to the maximum level of leverage set for an AIF may vary according to changes in the market. What factors should we take into account in determining what constitutes a material change?

Most venture capital/private equity funds do not use leverage at the fund level. However managers using some structures (for example listed companies) and some strategies (for example lower risk mezzanine debt funds) may choose to employ a modest level of leverage in some circumstances in order to manage liquidity and enhance investor returns. Any such intended application or permissions are set out in the AIF's formation documents. Any material change needs to be

assessed only in regard to the maximum level of leverage set for an AIF to which investors have contractually agreed in the AIF's formation documentation.

Q16. A material change to the maximum leverage limit set by an AIFM must be disclosed to investors and to us. Operationally, what will be the best way to report this to us?

We would suggest that a short notification in writing or via ONA to the FSA would be appropriate. The change will usually require the consent of investors (or at least confirmation to them) and should therefore be sent to the FSA after any consents have been obtained/ notifications given.

Q17. What are the particular challenges for your firm as a result of the delegation requirements? How will this affect existing operational structures?

It is difficult to be able to discuss with any meaning the challenges that the delegation requirements will impose on AIFM until it is clear precisely which functions the AIFM will be obliged to perform.

ESMA has complicated this issue with its Discussion Paper on Key concepts of the Alternative Investment Fund Managers Directive in particular at III Definition of an AIFM. Our thoughts on this issue have been set out in the European Private Equity and Venture Capital Association ("EVCA") response to the ESMA Discussion Paper and we will send a copy of this response to you. We have two key concerns. First, we disagree with ESMA that the AIFM should not be able to delegate the whole of both the portfolio management and risk management functions simultaneously. Provided it does not become a letterbox entity, there is no restriction on the extent to which an AIFM can delegate portfolio management and risk management functions, which could include the whole of each function. Second, we disagree with ESMA that an AIFM should be deemed to be responsible for the functions in paragraph 2 of Annex 1 to the Directive.

It is also important to distinguish delegation as defined under MiFID (whereby a service provider performs a process, a service or an activity which would otherwise be undertaken by the [AIFM] itself) from the procurement by the AIFM of services for which it would not otherwise be responsible. For example, an investment manager appointing an investment adviser should not be considered as "delegating" to the adviser as this is not a role that the investment manager would otherwise be undertaking.

Q18. 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?

As this is a detailed and complex subject in its own right, we have attached a separate paper as part of this response addressing our understanding of the capital and PII requirements in the Directive.

Q20. Do you expect to want to use a guarantee to meet part of the additional own funds requirement?

We do not believe firms have yet considered this. We propose the UK rules should give UK firms the flexibility to do this.

Q21. Do you have any comments on how AIFMs might comply with any PII requirements adopted in Commission implementing measures based on the ESMA advice?

We welcome the acknowledgement in the discussion paper that the FSA's implementation of the PII requirements must reflect the nature of the UK market for PII. The requirements will be redundant if there is no PII policy on the market which can meet the requirements (and this would undermine the Directive, which makes clear that AIFM must have a choice between PII and additional funds). We supported the EVCA submissions to ESMA during the Level II consultation process which seek to ensure that the Level II requirements are designed in a way which allows insurers to offers compliant policies. The PII proposals in the final report contain a number of significant improvements over the proposals on the initial consultation paper when considered from the perspective as to whether PII can be purchased. In particular, Box 9 of the original consultation required that there be no exclusions regarding the liability risks listed; that requirement was not included in the final report. Such a requirement clearly would have been impractical as all professional indemnity insurance policies contain exclusions. It would not be practicable for a regulator to seek to define the permitted list of exclusions as these vary amongst providers, dependent on market circumstances and depending on the circumstances of the insured.

Q22. To what extent do you expect to use PII as part of the required financial resources to cover professional negligence risks?

We expect that if PII cover is available on the market which meets the requirements, many firms will utilise this to meet the requirements of the Directive in whole or in part. We understand that many UK private equity managers currently have professional indemnity insurance and expect that they will be considering whether this meets the Level II requirements.

Q23. Do you have any comments on the most appropriate approach to determine the prudential requirements for internally managed AIFs?

Please see our separate paper.

Q24. Do you have views on the intended meaning of CAD-defined terms and our approach to incorporating them in the rules for AIFMs?

Please see our separate paper.

Q25. What are the most significant considerations that we should take into account when assessing the need to require AIFMs to have their valuation procedures and/or valuations verified by an external valuer or auditor?

Given all the other protective measures, including the role of the auditors and oversight of depositaries, the FSA should only exercise their power under article 19(9) in extremis, for example where there is a clear question over the valuations produced internally. The provisions of article 22(3) require the accounting information in the annual report to be audited and the audit report, including any qualifications, to be published in the annual report. This reduces the likelihood of valuations being incorrect.

Considerations that the FSA may take into account when assessing an AIFM's need to appoint an external valuer include:

- if the auditor's report contains a material qualification in respect of valuations;
- if there are significant deviations from industry norm valuation policies (i.e. IPEV, or RICS property valuation guidance) during the period in question;
- management incentives are materially linked to the value of the portfolio; and
- where there is no appropriate segregation between the valuation function and the investment decision making process.

Q26. What professional guarantees by an external valuer would be sufficient to show that it can meet the requirements of the Directive?

The FSA could consider the following professional guarantees:

- evidence of professional registration;
- evidence of the qualification of staff;
- reasonable professional insurance cover;
- evidence of the valuations standards used by the valuer; and
- disclosure of conflicts of interest in relation to the AIFM.

Q27. How should the NAV calculation requirement apply to an AIF that does not use the 'share/unit' concept?

It is already established that the 'share/unit' concept does not apply to venture capital/private equity funds. It therefore seems appropriate for the NAV to be provided in real terms rather than as a "per unit" figure.

Q28. Are there any particular challenges for your firm as a result of the liquidity requirements?

Venture capital/private equity funds are typically closed ended and do not offer investors the opportunity for redemptions. Instead, amounts invested are returned when underlying assets are sold. The requirements are of limited relevance to such funds. (There is an active and growing secondary market for interests in such funds. Also, a number of closed ended venture capital/private equity funds are listed. In both cases it is important that an efficient secondary market is permitted. Such secondary market activity is not, however nor at the initiation of, the AIFM or run by it).

Q29. What criteria should we take into account when considering whether arrangements of capital commitments might be temporary in nature?

Criteria which should be taken into account when considering whether a borrowing arrangement is temporary should be limited to those which put the duration of the borrowing into the context of the life of the fund. These include:

- any limitation on borrowing periods agreed with investors and set out in the fund's formation documentation;

- the limitation on borrowing periods set out in the documentation pertaining to the specific borrowing arrangements;

- the expected period of any borrowing, considered in the context of the expected life of the fund – for instance borrowing for up to 12 months may be considered to be temporary where a fund's life is 10 years or more;

- where borrowing is covered by capital commitments and the intention is to repay borrowings out of those commitments, then by its very nature that borrowing must be temporary.

One factor which should not be taken into account is structure or description of the borrowing arrangement. For example a "revolving credit facility" is not a definitive term as to the operation

of a loan arrangement. It is, rather, a description of the proposed access arrangements to credit rather than the longevity of the loan.

Q30. In what instances do you consider that neither the Gross nor Commitment methods of leverage calculation would provide a reasonable or approximate reflection of leverage within an AIF?

As set out in our response to Q15, in most cases, private equity funds do not use leverage. Where they do it is likely to be very modest and limited to very simple borrowing arrangements. As a result, the Gross or Commitment methods for calculating leverage are likely to provide reasonable reflections of private equity funds' leverage in almost all instances.

Q35. What are the implications, if any, of the remuneration disclosure requirements for those firms already subject to the provisions of the FSA's Remuneration Code?

A small number of private equity firms are already subject to the FSA's Remuneration Code and therefore are already making remuneration disclosures. As discussed at Q8 and Q9, it is important that the disclosure requirements under the Directive are aligned insofar as is possible with the existing Code disclosure requirements, to avoid unnecessary duplication or re-working for those firms which are affected by both sets of rules. We would welcome a consistent application of the proportionality concept across both sets of rules.

In particular it is important that the definition of Code Staff is maintained when implementing the Directive. A different definition of the individuals to whom the disclosure requirements apply would lead to two sets of disclosures and a high risk of confusion. It would also increase the risk of an individual's specific remuneration being disclosed by comparing the two sets of aggregated information.

Q36. What are the implications for firms currently outside the Remuneration Code, e.g. real estate funds and private equity firms?

Managers of private equity and real estate funds are accustomed to making disclosures in their funds' periodic reports to investors regarding the amounts of fees payable and any carried interest paid for each financial period.

Many managers will not make an allocation of remuneration between the funds they manage. Executives will often have responsibility for investments in a number of companies, which are spread across a number of funds. It is unusual for a manager to require executives to record how they allocate their time, principally because fees are not charged on this basis.

The implications of these disclosure requirements are that managers will have to make additional disclosures in the reports of their funds, which investors have never required previously, thereby incurring additional time and expense.

We also emphasise the importance of ensuring that the remuneration of an individual is not explicitly or implicitly divulged through any of the required disclosures. That is not the intention of the rules and it would be of no advantage to investors. This is a particular risk for small firms and we ask the FSA to consider specific provisions for firms with three or fewer individuals to whom the aggregate disclosure requirements might apply.

Q37. Reporting by third country AIFMs marketing AIFs in the UK will need to be captured. There is no current process for this. What do you believe would be a practical solution for this?

It is important that the reporting requirements for such third country AIFM are as accessible as possible and that the FSA requests only that information which is strictly necessary. Flexibility is key, the information must be capable of being provided directly and easily.

Where a third country AIFM has an affiliate in the UK, it could, at its option, provide the required information through this affiliate. The FSA may also wish to offer third country AIFMs the option of the FSA liaising directly with the home regulator.

Q38. While a depositary is a feature of FSMA-authorised funds (including NURS), the requirement to ensure the appointment of a depositary for unregulated CIS represents a change for UK AIFMs. What additional costs and benefits might this change give rise to?

(a) Additional costs of a depositary

There is no doubt that the requirement for each AIF to appoint a depositary will add significant costs and that these costs are likely to be passed on to investors in those funds. However, it will be difficult to quantify those costs until the detailed level 2 rules are finalised because:

- there are currently very few organisations offering even standard custody services to venture capital/private equity funds and therefore the expected charges are unknown;
- very few venture capital/private equity firms currently use standard custody services; and
- the Directive imposes a significantly higher burden on depositaries than exists under any current regimes and therefore costs for depositaries under the AIFMD are not comparable with costs for depositaries or custodians acting under existing legislation.

The areas of the Directive which lead us to conclude that costs are likely to be very high are:

- the likely "strict" liability regime which means that depositaries will face a high level of risk from appointments, for which they will want to be adequately compensated; and

- the potentially very detailed record keeping requirements, which may require a depositary to keep an entirely separate and complete set of books and records to those maintained by the AIFM or their administrator.

(b) Additional benefits of a depositary

We cannot identify any material benefit to investors from the depositary requirements. It is extremely rare for investors in venture capital/private equity funds to require managers to appoint depositaries in respect of their funds. We are not aware of any reported instances where venture capital/private equity fund managers have fraudulently claimed that a fund owned assets which it did not and investors judge that the risk of loss or fraudulent misstatement of unquoted assets is extremely low.

Accordingly it is difficult to see that investors will benefit in any material way from the appointment of depositaries for venture capital/private equity funds. In addition the cost requirements imposed on AIFMs will track through to the profits available for investors. We expect that in time some firms will establish two funds, one onshore Europe for European investors which will bear all the costs of AIFMD compliance, including the depositary, and one offshore to provide a less costly option for other investors.

Q39. 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?

We do not know at this stage whether such entities will offer depositary services to the venture capital/private equity market. To date they have not really done so within the UK as there has been no commercial requirement from investors to pay for this kind of service and there has been a limited offering by mainstream depositaries in relation to unquoted private company investments. We are concerned that it may be very difficult to find entities willing to offer depositary services to venture capital/private equity AIF and that there will be very little competition in this field, unless the UK exercises the option on which we comment under Q40. We see no reason to increase the capital requirements of the entities listed just because they are also AIFMD depositaries. A depositary, when acting as such is not a deposit taker. Capital requirements would never be

sufficient to cover the loss of a large number of assets, segregation is the key to investor protection here. We see no particular reason to increase the capital requirements for depositaries within the third bullet of paragraph 7.3, and we doubt that insurance is available or suitable. Parent/subsidiary relationships are infinitely variable and there can be no generally correct answer to the question raised.

Q40. 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?

(a) Organisations intending to offer depositary services to private equity funds

We strongly support the UK making use of the Member State option to allow other entities to offer depositary services to the type of AIF referred to in paragraph 7.7 of the Discussion Paper, which will include the majority of venture capital/private equity firms which will be subject to the Directive. This is the most likely way to limit the cost to AIF (and therefore investors) and disruption to managers of appointing a depositary, which, as set out in the answer to Q38, we consider will be of no material benefit to investors or contribute to any reduction in systemic risk more broadly.

We understand that a few organisations are considering offering depositary services to venture capital/private equity funds. These include firms currently providing fund administration services, as well as those currently providing depositary or custody services to other branches of the fund management industry. We are not aware of any lawyers or accountants intending to provide these services.

However such firms face potentially significant hurdles in doing so.

These hurdles include:

- the strict liability regime;
- mandatory professional registration; and
- the provision of sufficient financial and professional guarantees.

In respect of the last two of these, we urge the FSA to keep such requirements to a minimum in order to allow a sufficient number of providers to come forward to create a market for these services. There is a high risk, in our view, that the number of providers could be very small, resulting in a monopoly or duopoly of the market which will in turn lead to lack of choice, uncompetitive fees and uncompetitive service provision.

(b) Appropriate prudential regime for depositaries to private equity funds

EU competent authorities might rely on a range of prudential measures to assess the ability of a depositary to meet its obligations, such as:

- governance arrangements;
- professional indemnity insurance cover;
- regulatory capital;
- guarantees from other regulated entities (e.g. banks and investment firms);
- indemnities and guarantees from other persons.

It is also critical that prudential requirements reflect that in reality depositaries for different types of AIF will have potentially different functions and exposures in practice. A depositary for a venture capital/private equity AIF will have few (if any) investments that must be held in custody as defined by the Directive and accordingly will have different prudential risk profile.

Our preference would be to allow depositaries maximum flexibility as to which measures to use and in what combination. If the initial bar is set at £4m regulatory capital (or a higher flat threshold), we think this will exclude many potential participants suitable for the venture capital/private equity market (e.g. administrators) who have the skills needed to perform the venture capital/private equity depositary function.

As noted in our answer to Q39 above, depositaries which are not also licensed as credit institutions or investment firms will not be using regulatory capital to support deposit taking or other banking activity. It is important that the prudential regime applied to such AIFMD depositaries reflects this.

(c) Level of financial and professional guarantees to be given by depositaries to private equity funds

We consider that depositaries should be able to provide documents which evidence the qualifications/relevant experience of their staff, their financial condition, their registration with a relevant professional body and reasonable insurance cover.

(d) Other FSA requirements to be applied to depositaries to private equity funds

It is important that any application of additional FSA requirements acknowledges that the risk profile of AIFMD only depositaries is far more limited than that of other EU financial institutions which are also credit institutions/investment firms.

Q41. Do you agree with our view that a depositary, in having to meet its existing FSA requirements, may already be carrying on most or all of the Directive requirements in relation to monitoring cash flow? If you disagree, what costs and benefits do you consider the Directive requirements will impose?

We do not agree with this view. It is only potentially correct in relation to UCITS depositaries. The FSA custody and client money regimes are not the same. For UK venture capital/private equity funds, the cash flow monitoring requirement will be entirely new.

Under the Directive, we expect that the entire AIFM population will be divided between a very small number of depositaries. Their charges may be significant to reflect their liability profile. This cost will be passed on to the AIF clients. We cannot foresee any material benefit to the AIF or to the investors as a result of these requirements.

Q42. What other categories of assets would not be required to be registered by the depositary in a segregated account?

We think the classes of investments given at paragraphs 7.15 and 7.16 are the main classes. The only asset which we consider may not have been included would be carbon emission credits.

Q43. Do you agree that no additional guidance is required for the verification of assets, and it is appropriate for the depositary to exercise its professional judgement to assess what information is required in different circumstances? If not, what assets do you consider need further guidance and what steps do you consider relevant to verify ownership of those assets?

We note that the level 2 rules regarding the verification of assets are not yet finalised. However the rules recommended by ESMA (at box 81 of its Final Report) appear to us to be very comprehensive. If the Commission adopts final rules in a form similar to this, we agree that no additional guidance from the FSA will be necessary or desirable in this area. We agree that it is appropriate for the depositary to exercise its professional judgement in line with its regulatory obligations to assess what is required.

Q44. When carrying out their valuation oversight duties, how will depositaries ensure that the valuation procedures are appropriate with regard to the nature, scale and complexity of the AIF under management?

This will ultimately need to be a question of judgment and the practice will evolve once the regime is in place. We expect that depositaries will need to do the following:

- become familiar with the business of the AIFM including the types of assets that are being valued and the typical valuation methodologies used;
- establish whether an external valuer been appointed; and
- where an external valuer has not been appointed, understand the safeguards that have been put in place to ensure the functional independence within the firm and how conflicts are appropriately managed.

Based on this, and on their professional judgement, the depositary should be able to identify if there are appropriate procedures in place to perform the valuations. However, if it remains unclear then the depositary could discuss the issue with the AIFM's auditor or external valuer (where relevant). In cases where the depositary is still unable to establish whether the procedures are appropriate it may need to undertake a detailed review of the valuation methods.

Q45. 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?

As noted in paragraph 7.20 of the Discussion Paper, neither the Directive nor the level 2 rules contain any restriction on a company in the same group as the AIFM providing depositary services to funds managed by that AIFM. We urge the FSA not to create any such restriction or any further set of requirements on such firms as we do not consider that this would provide any safeguards to AIF and would act simply to increase costs and reduce competition.

Any group firm undertaking depositary services would be required to comply with the same FSA regime as any independent depositary, including the prudential requirements, financial and professional guarantees and any other FSA requirements. It would also have to comply with the level 1 and level 2 rules for depositaries, which set out clearly the required performance levels.

Q50. It is possible that the Commission with national regulators may consider the definition of 'marketing' in AIFMD transposition workshops during 2012. With this in mind, which marketing practices do you consider may be within the definition of 'marketing' in article 4(1)(x) of the Directive? Which practices should not be considered as 'marketing'?

The definition of "marketing" in the Directive is "a 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".

In our view, it is clear that there must be an offering or placement. The marketing process in the context of private equity is distinct from many other types of AIF. Firms may conduct investor relations exercises, pre-marketing activities and discussions about potential fund structuring without there being anything to "offer" to the investor, and indeed there may never be anything. These are all a preliminary to the point where an offer/placement is made. We do not think that these activities are marketing as defined, indeed they cannot be as there is nothing to which the Directive's notification provisions can attach.

Marketing private equity AIF is more akin to a negotiation process than an "offering" of a fixed arrangement. The details described in Annex III of the AIFMD are not fixed or even drafted before the AIFM begins discussions with potential investors. It is therefore important that the notification provisions apply at the point where they can be given substance. We would be delighted to work with the FSA to reach a constructive understanding on the application of these provisions.

Q51. Which material factors should also be considered when determining whether the activity of offering or placement of units or shares in an AIF falls within the Directive 'marketing' definition?

Any rules in relation to this must recognise that the terms "offering" and "placing" are not commonly associated with interests in venture capital/private equity funds and relate typically to listed securities. As noted above we do not think that "offering" and "placement" relate to pre-marketing activities. As under the current regime, there is also a difference between the activities of marketing an interest and the activity of arranging and advising on that investment. This distinction should be carried forward into the regime under the Directive.

It is clear that the sale of secondary interests does not fall under the Directive's definition of "marketing" as it would not be done on behalf of or at the initiation of the AIFM. It is also clear that an intermediary which offers or places fund interests for a seller in a secondary transaction would not be within the scope of Article 6 (8) since that activity does not involve the AIFM, nor is such activity at the AIFM's initiation.

As an additional comment, we understand "marketed in accordance with the Directive" to mean "marketed as permitted under the Directive", so that it refers to marketing under the passport and under national private placement regimes. Any other interpretation would be illogical and would, for instance, prevent a non-EU general partner which is marketing under national private placement regimes from appointing an EU placement agent.

Q52. What else should we consider concerning the 'on behalf of the AIFM' element of the 'marketing' definition?

There must be some clear evidence of the connection between the firm doing the marketing and the AIFM. For example, firms which market secondary interests in venture capital/private equity funds or which market private equity funds of funds are not acting on behalf of the underlying AIFM when marketing the relevant investment (of course in the case of private equity fund of funds they are likely to be marketing interests in their own AIF). Firms which intermediate secondary fund interests should not be regarded as being within the marketing restriction on MiFID firms and credit institutions set out in Article 6 (8).

Q53. Should we create a distinct register or list for those non-EU AIFMs from whom we have received a notification of intention to market an AIF in the UK through national private placement?

There are a number of challenges in creating such a list as acknowledged in the Discussion Paper. There are also concerns that such a list may imply some oversight or permission granted by the FSA and investors may incorrectly conclude that they benefit from additional regulatory protections relative to those funds which are not listed. We do not see a need for any such list and if there is entry on it then such entry should be voluntary.

Q54. Do you agree that those listed AIFs marketed by virtue of a public offer are undertaking the activity of 'marketing' as defined in the Directive and are therefore subject to the relevant requirements?

In such circumstances, we consider that it would only be appropriate for listed AIFs to be subject to the Directive marketing definition at the IPO stage, or at subsequent further placement and offers of shares that are subject to the Prospectus Directive and/or to UKLA Listing Rules. Both the UKLA listing rules and Prospectus Directive define how such marketing can be conducted – those frameworks should be aligned to the Directive or vice versa.

It is clear that the daily trading of shares on a public exchange is not within the Directive's definition of 'marketing', and we strongly recommend that this is made expressly clear in the final implementing text.

Q55. Do you agree there are potential conflicts of interest between the role of the board in the context of the UK corporate model and the role of the AIFM? If so, which conflicts do you foresee?

We do not consider that there are potential conflicts of interests between an AIFM and the role of the board where these functions are carried out separately. Any potential conflicts are addressed already by the UK Corporate Governance Code, UKLA listing rules, FSA regulation and under existing company legislation, as well as through individually negotiated Investment Management Agreements (IMA) between a Board and its appointed investment manager. We do not consider

that any additional conflicts are brought about as a consequence of the Directive. Mechanisms for resolving any conflicts are already in place.

However, we consider that there may be significant issues if the board of a listed AIF were always required to become the AIFM. The role of a board is that of supervision and ultimate oversight. It does not have to perform management of the fund and may not have the expertise, resources or experience to only partially delegate these roles. It is important that full delegation is permitted at all times.

It is critical that the FSA does not adopt a one size fits all approach, the Directive does not require this. Flexibility is key, it is for the board to decide if it has the experience and expertise etc. to act as the AIF manager. Where appropriate it would be preferable for listed AIFs to review and amend their existing mandates with portfolio managers to conform to the Directive's structure on AIFM obligations rather than transfer the responsibility of the AIFM to the board.

We have examined potential conflicts to determine whether or not these would present themselves in practice. We do not find any examples of conflicts that could not be managed and addressed through the revision of existing investment management agreements or drafting of new investment management agreements to comply with the requirements of the Directive. We would be happy to have a discussion with the FSA specifically on this matter if that would be helpful.

Q56. Do you agree we should develop proposals to ensure that a premium listed fund must itself hold the AIFM permission envisaged under the Directive?

We do not agree with the proposal. We believe that appropriate contractual arrangements can be put in place between a board and the investment manager such that the board fulfils its responsibilities under UK corporate law, while the manager is the AIFM for the purposes of the Directive.

We believe it is very important that boards are afforded the maximum flexibility to comply with the Directive. The application of the Directive to listed investment companies is already highly burdensome, given that they are already subject to separate regulatory regimes. Adding further restrictions will make the UK a less attractive venue for listing investment funds, which runs counter to the aims of the recent simplification of investment trust tax rules and listing rules in the UK.

An unintended result of this proposal is that investment companies could apply for junior exchange membership thereby resulting in the potential for weaker governance and protections for shareholders which would be a self-defeating proposal.

We also note that it may not always be the case that a listed fund will fall under the definition of "AIF" for the purpose of article 4(1)(a) of the Directive and therefore a proposal for listed funds to become AIFMs would prevent listed funds which do not fall under the Directive from being able to list at all.

Q57. Should the listing regime, as far as possible, treat off-shore and other non-EU AIFs the same as EU AIFs?

EU and off-shore AIFs should be treated the same. If the listing requirements are sufficiently robust then there should be no reason why firms should be treated differently on the basis of domicile. If there are concerns about abuse, then this suggests that enforcement of the listing requirements has failed, not that it is a problem of domicile. The correct action would be to improve/tighten the listing requirements, rather than differentiate between jurisdictions.

Q61. What should we consider in permitting EU AIFs to be marketed to UK retail investors?

Listed AIFs can already be marketed to retail investors and are available for purchase either in a public offering or on the secondary market on a public exchange.

We consider that the existing requirements under the Financial Promotions Order and the Promotion of Collective Investment Schemes Order, when implemented properly, already provide a functioning framework for the promotion of investments to retail investors.

Q63. Which types of UK AIF are most likely to deem themselves as internally managed?

Where an AIF is structured by using partnerships, either with their own personality or not (which is the predominant venture capital/private equity model) it is important that it is clear that they will be free to be externally managed. Paragraph 9.38 of the Discussion Paper mentions that "It remains unclear whether these investment funds will be deemed internally or externally managed, including, for instance, in the case of an English limited partnership where the general partner may be the AIFM". We think that it is important to have clarity and certainty that partnerships can be externally managed and will not be <u>deemed to be</u> internally managed. The correct analysis in each case depends on the structure of the contractual arrangements.

Similarly whether or not a listed investment company is internally-managed in an AIFMD sense is a matter of fact, some will be but it should not be assumed that this is likely to be the case.

The FSA will need to look at the range of potential AIF vehicles (companies, partnerships with/without legal personality, LLPs, unit trusts and other contractual funds etc) and consider what it means for each to be internally managed. It will be important to deliver flexibility and choice so

that, consistent with the Directive requirements, all AIFs are capable of being either internally or externally managed and that implementing legislation will not restrict this.

The vast majority of venture capital/private equity funds are established as limited partnerships. These sometimes take the form of limited partnerships without legal personality (e.g. those that are established in England and Wales) or sometimes limited partnerships with legal personality (e.g. those established in Scotland). In a limited partnership, the investors in the funds become limited partners and therefore do not take part in the management of the fund.

In the context of the existing domestic regulatory regime (particularly bearing in mind the regulated activity of establishing, operating and winding up collective investment schemes) the vast majority of UK venture capital/private equity funds operate on the basis of an unregulated general partner who then (pursuant to a management agreement) appoints an associated entity (which is authorised by the FSA) to be the manager of that limited partnership. In such a structure the starting point should be that limited partnerships are not internally managed and where a manager is appointed they are or will be deemed to be externally managed for the purposes of the Directive.

Looking at this framework for the purposes of the Directive and assuming similar structures were used our view is that again the general partner would not be the AIFM if an associated entity in the group was appointed to be responsible for the investment management and portfolio management of the AIF. That is not to say it would be impossible for the general partner to be the AIFM (if it was decided by the promoter that the general partner itself should be responsible for the investment management of the partnership) but in most cases it will be the manager (who is not a partner in the limited partnership) that will be the AIFM. Even if the general partner undertook investment management itself we would take the view that it would be the AIFM, such that the limited partnership AIF would not be internally managed.

Q64. Which aspects of the current UK regulatory framework might present particular challenges for internally managed AIFs? (See also Q23)

The SYSC requirements would potentially be a challenge if an AIF such as an investment company were deemed internally managed. It might have only non-executives and delegate all executive functions to a third party organisation(s). Please also refer to our response in Q55.

Q65. What changes, if any, are necessary to the process or requirements for FSA authorisation for AIFMs in cases where the AIF under management takes the form of a partnership?

The FSA already authorises partnerships so we doubt that any changes are necessary, though it may be worth considering whether the approved person registration rules should apply to all the partners, particularly limited partners.

Q69. What other changes should we consider making to rules on the marketing and distribution of unregulated AIFs to retail investors?

We are generally supportive of the current regime. When followed properly, the combination of the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (as changed) and the FSA Rules functions properly. Accordingly we do not consider that further changes are required.

BVCA response to DP12/1
Schedule: Regulatory Capital Requirements

1. **General comments**

1.1 It is vital that the definitions **of initial capital and own funds are presented in an accessible way in the FSA Rules.** We note that the initial capital and own funds definitions are set out in the Capital Requirements Directive and are incorporated by reference in the AIFM Directive. We understand that when CRD is updated from 1 January 2013, the FSA is considering deleting the parts of its rules which set out the initial capital and own funds definitions for CRR firms and instead refer firms to the text of the Capital Requirements Regulation. We strongly recommend the FSA does not follow the same approach for AIFM, but instead follows the approach currently used for exempt CAD firms of including a bespoke set of definitions in its rules which summarise the CRR provisions. This should be easier for firms to understand and thus make it far more likely that firms will be in a position to ensure compliance. The CRR text is fantastically complex. Regulatory capital regulation forms one small (but important) part of the AIFM Directive regime, rather than (as is the case for banks etc. subject to CRR), its central plank. We expect both internal AIFMs and external AIFMS would struggle to apply Basel III complexity to the calculation of initial capital and own funds requirements: we also consider that the cost involved in such detailed work would be completely out of keeping with any regulatory benefit.

1.2 The AIFM Directive is applicable to **a wide range of legal entities** which may be internal or external AIFM. The FSA needs to interpret the directive purposively to ensure that the industry standard vehicles which are used for these structures are permitted to use capital structures which meet the definitions of initial capital and own funds. The CRR is expected to contain limits on the definitions of initial capital and own funds which are designed with publicly listed internationally active banks in mind, all of which are structured as limited companies. The AIFM world is far more varied, including private companies, public companies, partnerships, limited liability partnerships and other structures. There has never been any suggestion that the intended policy effect of the AIFM Directive is to restrict firms from using the established structures as internal or external AIFM.

1.3 The AIFM Directive imposes no regulatory capital requirements on a registered AIFM, whether internal or external. Accordingly we recommend that the FSA does not impose any additional capital requirements on these entities.

2. **Internal AIFM**

2.1 An AIFM requiring authorisation as internal AIFM under the Directive may only perform the activities of an internal AIFM (Article 6(3)). This means it cannot be subject to the regulatory capital requirements of the CRD or UCITS. Accordingly we agree there is only one categorisation for such firms, as stated in para 4.51:

Initial capital requirement:	€300,000	(Art 9(1))
Own funds requirement:	None	
Additional own funds or PII:	As for external AIFM	(Art 9(7))
Liquid assets requirement:	None	

2.2 The ESMA Level 2 advice focuses on the professional indemnity insurance requirements for external AIFM. Assuming the Level 2 measures take the same approach, it will be important to recognise that on a purposive interpretation, a number of the requirements are not appropriate for internal AIF. For instance, in construing the PII requirements applied to internal AIF, the FSA should take account of the fact that the AIF cannot be liable to itself, only to investors.

2.3 We note with interest the point raised by the FSA in paragraph 4.66 that it may not be possible to distinguish between investor contributions to the funds and initial capital. Industry bodies made exactly this point during the passage of the legislation. Nevertheless the Directive does not distinguish investors contributions from initial capital for an internally managed AIFM: indeed this is the only place such initial capital could come from. We would also be interested to understand in more detail the promoter model described by the FSA in that paragraph.

2.4 Registered internal AIF (as opposed to authorised internal AIF) are not prohibited from engaging in MiFID or UCITs activities. They may be subject to either, both or neither of these directives.

3. <u>External AIFM</u>

3.1 We agree with the categorisation in 4.51, except that the third and fourth bullet points of para 4.51 (each entitled "AIFM Investment Firm") appear to be identical categories.

3.2 We think it unlikely that PE/VC firms will be UCITS firms. We accordingly limit our comments to AIFM and AIFM investment firms.

External AIFM

3.3 We understand the regulatory capital requirements for such firms will be:

Initial capital requirement:	€125,000	(Art 9(1))
Own funds requirement:	¼ fixed annual overheads	(Art 9(5))
Additional own funds or PII:	See below	(Art 9(7))
Liquid assets requirement:	Yes	(Art 9(8))

3.4 The liquid assets requirement is entirely new. We understand that the own funds covered by it are only those own funds which are required for the purposes of Art 9(5) and Art 9(7)(a). They exclude any other own funds (which can accordingly be used as working capital etc). (Indeed if this were not the case it would be difficult to see how a firm could function). We recommend that the FSA give firms flexibility on the choice of non-cash instruments which can be readily convertible to cash in order to be held for these purposes.

3.5 We would like to discuss the PII requirement in more detail with the FSA once the Level 2 measures are finalised. The key question is simply whether firms will be able to buy PII which meets the requirement. We note the FSA's proposal to refer to PII requirements imposed in relation to other directives when implementing the AIFM Directive measures. However we suspect that the Level 2 measures will be comprehensive and that the FSA will not need to go beyond a copy-out approach.

3.6 The additional own funds requirement is expected to include a qualitative requirement to hold adequate financial resources. It has been suggested that this may require external

AIFM to carry out an ICAAP and be subject to Pillar 2 requirements analogous to those set out in CRD. The Level 1 Directive does not include a Pillar II requirement for AIFM. It was open to the level 1 policymakers to introduce one but they did not do so. It would not be appropriate for such a requirement to be introduced at Level 2 and indeed this would go beyond the legal scope of level 1. Instead, we would understand any such requirement as reflecting the UK threshold condition concept of adequate financial resources. Any such requirement would not need any additional FSA rules, merely a guidance note reminding firms that this requirement already applies to them.

AIFM Investment Firms

3.7 We note that the only reference in the AIFM Directive to the application of CRD to AIFM performing portfolio management is set out in Art 11(d). It is not apparent to us that this requires the FSA to apply CRD in full; in particular it is not apparent from this reference whether the CRD requirements are to be applied on a consolidated basis or only on an unconsolidated basis. If the FSA were to apply CRD in full, we understand the outcome would be as follows:

Solo:

Initial capital requirement: €125,000 (Art 9(1))

Own funds requirement: Higher of (a) ¼ fixed annual overheads and (b) credit risk + market risk

Additional own funds or PII: Yes, but this means additional to the AIFMD requirement (so if test (b) in CRD is used, then any amount of credit risk plus market risk which exceeds the AIFMD ¼ fixed overheads requirement would count towards additional own funds)

Liquid assets requirement: Yes, but applies only to own funds required by art 9(5) and 9(7) of AIFMD, not any CRD own funds

UK liquidity requirement (currenly BIPRU 11): Yes

Consolidation:

As for a CRD investment manager (no AIFMD requirements apply on a consolidated basis)

3.8 We note that CRR is currently going through the legislative process. Any changes which affect portfolio managers could affect the above analysis.