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## **Investor protection: Towards additional EU regulation of investment funds?**

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## CHAPTER 3

# EU Investor Protection Law

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### 3.1 INTRODUCTION

This chapter deals with the second research question of this book: ‘How are EU and US funds available to EU retail investors currently regulated relating to the protection of investors?’. However, where the research question concerns the regulations applying to both EU and US funds, this chapter only considers the *EU* investor protection law applying to funds that offer their shares to EU investors or that could be indirectly of relevance to them. It will firstly set out the scope of the (passport) activities of the two categories of funds regulated under EU law, UCITS and AIFs, and the general criteria assessing whether or not a particular fund qualifies as either a UCITS or AIF (sections 3.2 & 3.3). The chapter will then turn to a thematic analysis of the different types of investor protection regulations applying to EU funds excerpted from Chapter 2, including: (1) internal control systems, (2) leverage restrictions, (3) rules related to investor meetings, (4) transparency and disclosure rules, (5) conduct of business rules, and (6) depositary monitoring duties (sections 3.4–3.9). Finally, the chapter will close with a conclusion (section 3.10).

### 3.2 UCITS

In Europe, about 70% of the assets under management of EU investment funds is invested by UCITS.<sup>1</sup> The UCITS form is a widely used form for funds since the adoption of the UCITS Directive in 1985.<sup>2</sup> The objective of the UCITS Directive is to be an

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1. EFAMA, *Trends in the European Investment Fund Industry in the Fourth Quarter of 2014 and Results for the Full-Year 2014: Quarterly Statistical Release*, 3 (showing that, by the end of 2012, UCITS net assets comprised of EUR 7,979 billion of the in total EUR 11,341 billion net assets under management).

2. See, e.g., C.D. Christian, K.S. Cohen & J.L. Wendell, *Offering UCITS to US Institutional Investors: A Post Dodd-Frank Overview-Part 1 of 2*, 19 *Inv. Law.* 3 (2012), C. Szylar, *Risk Management under*

optional framework to enhance the cross-border marketing and managing of funds within Europe while ensuring a minimum standard of investor protection.<sup>3</sup> It is thus aimed at enabling fund managers to profit from its principal advantage, the EU passport. This passport makes it possible for fund managers to sell UCITS to investors throughout the European Economic Area (EEA),<sup>4</sup> without further authorization in each Member State in which they wish to offer their shares.

The passport is provided to the UCITS management company and so-called self-managed UCITS.<sup>5</sup> It allows a UCITS management company or self-managed UCITS to pursue in other Member States the activities for which it has been authorized in its home Member State subject to a notification procedure ('home country control principle').<sup>6</sup> In order to prevent national Member States from imposing additional notification rules, a practice that occurred on a wide scale among Member States,<sup>7</sup> some improvements to the principle of home country control were made in 2009 by the

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*UCITS III / IV: New Challenges for the Fund Industry 3* (John Wiley & Sons 2010), and K.R. Johannsen, *Jumping the Gun, Hedge Funds in Search of Capital under UCITS IV*, 5:2 Brook. J. Corp. Fin. & Comm. L. 473 & 475 (2011).

3. See the recitals of the original UCITS Directive (85/611/EEC, OJ L 375, 1985, 3), which make clear that the objective of the directive is to take away regulatory differences that distort the competition between funds and to ensure investor protection, rather than providing for a mandatory framework to regulate funds ('national laws governing collective investment undertakings should be coordinated with a view to approximating the conditions of competition between those undertakings at Community level, while at the same time ensuring more effective and more uniform protection for unit-holders').
4. The EEA includes the EU Member States and the three EEA countries: Iceland, Liechtenstein and Norway. Switzerland, has not joined the EEA, but has a similar agreement with the EU. See <http://www.efta.int/eea/eea-agreement.aspx>, last accessed on 21 Aug. 2013. In this book, when referring to the EU in the context of the EU passport, it will be meant the EU Member States and countries that are party to the EEA agreement.
5. The management company passport was introduced in 2001 by the UCITS III Management Company Directive. Directive 2001/107/EC of the European Parliament and of the Council of 21 Jan. 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses, OJ L 41, 20–34 ('the UCITS III Management Company Directive').
6. Recital 8 of the preamble to the UCITS III Management Company Directive ('[A] management company should be authorised in the Member State in which it has its registered office. In accordance with the principle of the home country control, only the Member State in which the management company has its registered office can be considered competent to approve the fund rules of unit trusts/common funds set up by such a company and the choice of the depositary. In order to prevent supervisory arbitrage (...), a requirement for authorisation of a UCITS should be that it should not be prevented in any legal way from being marketed in its home Member State').
7. A research performed by the Fédération Européenne des Fonds et Sociétés d'Investissement (FEFSI) and PwC in 2001 showed that Member States impose several regulatory constraints on UCITS, varying from additional registration and information requirements to national marketing, distribution, delegation and taxation requirements that must be met in order to maintain the UCITS authorization. For example, at 2001, in Belgium, all the registration documents must be translated into at least one of the three national languages (French, Dutch, German) and French law required all documents to be translated into French and sometimes additional information is required a few days before the expiry date which extends the time taken to receive a notification. See FEFSI & PwC, *Cross-Border Marketing of 'Harmonised' UCITS in Europe, Current Situation, Constraints and Ways Forward* (November 2001). The research report can be found at FEFSI's website: <http://www.fefsi.org/>.

UCITS IV Directive.<sup>8</sup> Under UCITS IV, host Member States are prohibited from imposing any additional notification requirements other than those provided in the directive. Furthermore, UCITS IV permits the marketing of UCITS shares in another Member State immediately after the transmission of the notification letter accompanied by complete documentation in the home Member State, which effectively reduced the notification period from two months to ten days.<sup>9</sup> UCITS IV also replaced the simplified prospectus with a new document: the Key Investor Information document (KII).<sup>10</sup>

In order for a fund to qualify as an UCITS, an investment fund must meet certain requirements. According to Article 1(2)(a) and (b) of the current UCITS Directive, UCITS are undertakings ‘with the sole object of collective investment in transferable securities or in other liquid financial assets (...) of capital raised from the public and which operate on the principle of risk-spreading’ and the shares of ‘which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings’ assets’. It follows from this description that UCITS: (1) must be open-ended in nature, (2) must invest capital raised from investors by promoting the fund to the public, and (3) have the single objective to invest solely in a limited list of eligible assets and on the basis of risk-spreading. For the first two requirements, it can be referred to sections 2.2.1 & 2.6.2 relating to the features of funds in general. Below, only the UCITS-specific features, including the eligible assets in which UCITS are allowed to invest and the rules on risk-spreading applying to them will be discussed (sections 3.2.1 & 3.2.2.).

Furthermore, in order for a UCITS management company or self-managed UCITS to pursue activities in the EU, it must be authorized by the competent authorities of its home Member State. The competent authorities may not authorize a UCITS management company/self-managed UCITS if the investment fund does not comply with a number of preconditions set out in the directive. As UCITS shares can only be marketed in the EU with prior authorization of the competent Member State, the qualification of

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8. Recital 8 of the preamble to the UCITS Directive (‘The approach adopted in this Directive is to ensure the essential harmonisation necessary and sufficient to secure the mutual recognition of authorisation and of prudential supervision systems, making possible the grant of a single authorisation valid throughout the Community and the application of the principle of home Member State supervision’). This approach follows an advice by the CESR on issues arising in connection with the management company passport requested by the Commission. *See* CESR’s advice to the European Commission on the UCITS Management Company Passport, CESR/08-867, October 2008, 6 (‘The management company’s home Member States should be the Member State in which the management company’s registered office is situated or, if the management company has, under its national law, no registered office, the Member State in which the head office is situated’).
  9. Article 19(1) and (3) and 18(2) of the UCITS Directive. The home Member State has no later than ten working days after the date of the initial request to transmit the filing, effectively reducing the notification period from two months to ten days. Article 93(3) of the UCITS Directive.
  10. Recital 59 of the preamble to the UCITS Directive. Other changes introduced by the UCITS Directive are a framework for cross-border mergers between UCITS, the establishment of cross-border master-feeder UCITS structures, and measures to improve cooperation between supervisors. *See* recitals 21, 28, and 51 of the preamble to the UCITS Directive and the corresponding provisions. *See* on the KII, section with respect to the de minimis rents 3.7.1[B].

being a UCITS is meaningless without this authorization. Therefore, these authorization requirements will also be briefly discussed below (section 3.2.3).

### 3.2.1 Eligible Assets

UCITS may only invest in 'liquid financial assets'.<sup>11</sup> They include, among others, transferable securities, deposits, money market instruments, other UCITS shares and financial derivatives.<sup>12</sup> Originally, UCITS were only allowed to invest in transferable securities. However, revision of the UCITS Directive in 2001 by the UCITS III Product Directive has expanded this list to include other liquid assets as well, including financial derivatives.<sup>13</sup> The idea behind requiring UCITS to invest in exclusively liquid assets stems from the fact that they have an open-end structure and must therefore be able to re-purchase their shares at any time at the request of investors, as required by Article 84 of the current UCITS Directive.<sup>14</sup> In order to meet sudden redemption requests, UCITS may need to sell (part of) their underlying portfolio assets. The risk that investors could not redeem their shares due to a cash problem at the UCITS was considered minimal in case the UCITS' portfolio is sufficiently liquid.

Under the current UCITS Directive, financial assets must meet certain criteria in order to be qualified as eligible *liquid* financial assets under the directive. So may UCITS invest part of their assets in other funds, provided that certain risk-spreading rules are met (see section 3.2.2). This practice is used by many UCITS.<sup>15</sup> Short selling is not allowed under the directive, whether it includes 'covered' or 'uncovered' short selling.<sup>16</sup> See on short selling in general, section 2.6.6[A]. With respect to financial derivatives, the directive requires that UCITS may invest in such instruments provided that the underlying of the derivative consists of eligible instruments covered by the directive, financial indices, interest rates, foreign exchange rates or currencies, in which the UCITS may invest according to its investment objectives.<sup>17</sup> OTC derivatives

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11. Articles 1(2)(a) and 50 of the UCITS Directive.

12. Article 50(1) of the UCITS Directive.

13. Directive 2001/108/EC of the European Parliament and of the Council of 21 Jan. 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS, OJ L 41, 35 ('the UCITS III Product Directive').

14. CESR's Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS Consultation Paper, CESR/05-064b, March 2005, 9.

15. In 2011, more than 80% of the newly launched UCITS funds of hedge funds used the FoF structure. See G.N. Gregoriou (ed.), *Reconsidering Funds of Hedge Funds: The Financial Crisis and Best Practices in UCITS, Tail Risk, Performance, and Due Diligence*, 97.

16. See Article 89 of the UCITS Directive (prohibiting uncovered short selling) and European Commission, Letter of the DG Internal Market and Services: Psychological short-selling in the context of the UCITS Directive – March 2007 CESR guidelines on eligible assets, MARKT/G4/dm/D(2008) 4056, 11 Apr. 2008, 2 (considering that physical short selling of borrowed securities is inconsistent with important provisions of the UCITS Directive since '[t]he mere fact of borrowing the security to cover potential obligation to settle the short sale does not mitigate the exposure of the UCITS to potentially unlimited risk' and 'the prohibition on borrowing laid down in (...) [a]rticle 36 [of the UCITS Directive] – except on limited and temporary basis – is not confined to borrowing money but also extends to securities').

17. Article 50(1)(g)(i) of the UCITS Directive.

are allowed in case the counterparties to the transactions are subject to prudential supervision and that the derivatives are subject to 'reliable and verifiable' valuation and can be sold at any time at their fair value.<sup>18</sup>

The UCITS Directive contains a number of definitions related to the eligible financial instruments or their underlying components. However, since the adoption of the directive, the variety of financial instruments traded on financial markets has increased considerably. Therefore, in 2007, the European Commission adopted an implementing directive on the clarification of certain definitions in the UCITS Directive ('the UCITS Eligible Assets Directive').<sup>19</sup> In addition, CESR has published separate guidance concerning eligible assets for investment by UCITS.<sup>20</sup> In this respect, the definition of 'financial indices' is particularly interesting. An increasing amount of UCITS are nowadays investing in index-based financial derivatives.<sup>21</sup> The UCITS directive does not state when an index is eligible for covering derivatives. In the UCITS Eligible Assets Directive, this is further defined. According to this directive, financial indices must be 'sufficiently diversified, which represent an adequate benchmark to the market to which they refer and (...) [be] subject to appropriate information regarding the index composition and calculation' in order to qualify as financial indices on which derivatives may be based.<sup>22</sup> The directive also sets out more detailed criteria, including the requirement that the index must be revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers, that its underlying assets are sufficiently liquid, and that material information about the index, such as index calculation, rebalancing methodologies, index changes or any operational difficulties in providing timely or accurate information, is to be provided to investors.<sup>23</sup>

Although the UCITS Eligible Assets Directive gives some clarity as to the interpretation of financial indices for investments by UCITS, it still leaves the door open for Member States to interpret certain criteria in a different way. For example, it does not define the frequency of 'periodically' and when something is 'sufficient'. On the basis of the directive, CESR stated that indices based on financial derivatives on commodities or indices on property may be eligible in case they comply with the criteria set down in the UCITS Eligible Assets Directive.<sup>24</sup> Regarding derivatives on

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18. Article 50(1)(g)(ii) and (iii) of the UCITS Directive.

19. Commission Directive 2007/16/EC of 19 Mar. 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions, OJ L 79, 11 ('UCITS Eligible Assets Directive'). The power to clarify definition in the UCITS Directive is provided by the Commission in Article 53a of the original UCITS Directive of 1985 'in order to ensure uniform application of [the] Directive throughout the Community'.

20. CESR's guidelines concerning eligible assets for investment by UCITS, CESR/07-044, March 2007.

21. G.N. Gregoriou (ed.), *Reconsidering Funds of Hedge Funds: The Financial Crisis and Best Practices in UCITS, Tail Risk, Performance, and Due Diligence* 99 (Elsevier 2013) (stating that, at the first quarter of 2012, 24.5% of the total number of UCITS funds of hedge funds are index funds or ETFs, comprising 26.1% of the total UCITS funds of hedge funds' assets under management).

22. Recital 11 of the preamble to the UCITS Eligible Assets Directive.

23. Article 9 of the UCITS Eligible Assets Directive.

24. CESR's guidelines concerning eligible assets for investment by UCITS, 10.

hedge fund indices, CESR issued specific guidelines in July 2007.<sup>25</sup> In these guidelines, CESR stated that, in addition to the requirements applicable to financial indices and derivatives, hedge fund indices are eligible in case the UCITS meets additional requirements relating to the ‘adequate benchmark requirement’ and appropriate due diligence on the quality of the index.<sup>26</sup>

The CESR guidelines were reaffirmed and expanded in 2012 by ESMA.<sup>27</sup> Furthermore, the ESMA guidelines require, among other things, that an index should be transparent and replicable. Rebalancing more frequently than weekly is no longer allowed, with an exception for technical adjustments.<sup>28</sup> This effectively restricts the investments of UCITS in derivatives on indices that are based on highly active strategies, such as most hedge fund strategies, as these indices may be rebalanced on an intra-day or daily basis. Another requirement following from the ESMA guidelines is the requirement that the index methodology must be published in a way that enables investors to replicate the index should they wish to do so. This includes describing all the underlying components of the index.<sup>29</sup> This may rule out indices of which the components or the weighting of a component within a subindex change over time due to frequent rebalancing. Lastly, ESMA considers, in determining whether or not the index is sufficiently diversified, sub-categories of a commodity as the same commodity. Therefore, a commodity index that invests heavily in a part of the commodity market, will not meet the diversification requirements. UCITS that invest in derivatives based on commodity strategies are known as Commodity Trading Advisor (CTA) UCITS. CTA UCITS use indexes to replicate the performance of funds investing in commodities because of the restriction of the UCITS Directive of investing directly in commodities, including commodity futures.<sup>30</sup>

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25. CESR’s guidelines concerning eligible assets for investment by UCITS, The classification of hedge fund indices as financial indices, CESR/07-434, July 2007.

26. *Ibid.*, 6–8.

27. ESMA, Report and Consultation paper: Guidelines on ETFs and other UCITS issues – Consultation on recallability of repo and reverse repo arrangements, ESMA/2012/474, 25 Jul. 2012.

28. *Ibid.*, 51. The Q&A provides further guidance as to what is meant by ‘technical adjustments’, stating such adjustments include adjustments which are based solely on algorithmic non-subjective frameworks, are generally published on an ex-ante basis, draw on publicly available criteria (or data), and do not rely on the judgment of the index-provider, for example, indices which follow mechanical rebalancing formulae. See ESMA, Questions and Answers, ESMA’s guidelines on ETFs and other UCITS issues, ESMA/2014/295, 24 Mar. 2014, 10.

29. ESMA, Report and Consultation paper: Guidelines on ETFs and other UCITS issues – Consultation on recallability of repo and reverse repo arrangements, 51.

30. CTA UCITS increased in popularity over the past years. See UCITS Alternative Index, *Impact of the Recent Regulatory Changes on the UCITS CTA Market* 3 (10 Dec. 2012) (stating that the number of CTA UCITS funds has grown from nine to fifty-five funds from January 2008 to September 2012 and the assets managed by these funds have grown from EUR 1.57 billion to EUR 6.09 billion over the same period). The document can be found at <http://www.ucits-alternative.com/files/presse/UAIUCITSCTAMarket20121211.pdf> (last accessed on 16 Apr. 2014). It can be questioned whether the number and assets under management of this fund type, as a result of the new ESMA guidelines, will continue to grow.

### 3.2.2 Risk Spreading

The principle of risk spreading means that restrictions apply to UCITS which limit their spread of exposure, investments, and leverage. The restrictions build in certain levels of diversification with the aim of reducing the vulnerability of UCITS to the performance of a small number of assets. Central to this principle is the so-called 5/10/40 Rule. The 5/10/40 Rule is codified in Article 52(1) of the UCITS Directive. It concerns the risk exposure for UCITS and provides that no more than 5% of an UCITS' assets may be invested in transferable securities or money market investments of a single issuer. Member States may however raise the 5% limit to a maximum of 10% provided that, the exposure to these issuers, when added together, does not exceed 40% of the UCITS' assets.<sup>31</sup>

Furthermore, UCITS are allowed to invest 20% of their assets in deposits made within the same body.<sup>32</sup> In case of transferable securities and money market instruments issued or guaranteed by public authorities, Member States may raise the 5% limit up to 35% and in case of bonds issued by a credit institution up to 25%.<sup>33</sup> The limits may not be combined, as a result of which the total investments in transferable securities, money market instruments or bonds issued by the same body can under no circumstances exceed in total 35% of the UCITS' assets.<sup>34</sup> Another UCITS' risk exposure rule includes the rule UCITS may not combine investments in transferable securities, money market investments, deposits or exposures arising from OTC transactions that would lead to an investment of more than 20% in one single body. Companies included in the same group for purposes of consolidation are regarded as one single body.<sup>35</sup> With respect to OTC transactions, it can be noted that the risk exposure to a counterparty of a UCITS in an OTC transaction may not exceed 10% when the counterparty is a credit institution or, in all other cases, 5% of the UCITS' assets.<sup>36</sup> Furthermore, Member States are recommended to ensure that the global exposure relating to financial derivative instruments may not exceed 100% of the UCITS' NAV, and hence that the UCITS' overall risk exposure may not exceed 200% of the NAV on a permanent basis.<sup>37</sup>

In addition to the aforementioned and other risk exposure rules, a UCITS must comply with certain investment limits. For example, there are limits as regards the investments a UCITS can make into other funds. The UCITS Directive allows UCITS to

31. Article 52(2) of the UCITS Directive.

32. Article 52(1)(b) of the UCITS Directive.

33. Provided that certain conditions are met. See Article 52(2) and (3) of the UCITS Directive.

34. Article 52(5) of the UCITS Directive.

35. Article 52(2) and 52(5) of the UCITS Directive. Member States may however allow cumulative investment in transferable securities or money market investments within the same group up to a limit of 20%. *Ibid.*

36. Article 52(1) of the UCITS Directive. ESMA's Guidelines require that the risk exposures arising from both OTC derivative transactions and Efficient portfolio management (EPM) techniques, such as securities lending, should be combined when calculating counterparty risk limits. ESMA, Report and Consultation paper: Guidelines on ETFs and other UCITS issues – Consultation on recallability of repo and reverse repo arrangements, 48.

37. Commission Recommendation 2004/383/EC on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS), 25.

invest in other funds, provided that: (1) the investments in one single (UCITS or non-UCITS) fund does not exceed 10% (or maximum 20% in case a Member State has raised this limit) of its assets, (2) the investments in a non-UCITS fund does not exceed 30% of the total assets of the UCITS and the non-UCITS is considered by the competent authorities of the UCITS home Member State to be subject to equivalent supervision and investor protection as an UCITS fund and that cooperation between authorities is sufficiently ensured, (3) the underlying fund has not invested more than 10% of its assets in the shares of any other fund.<sup>38</sup> It follows from these restrictions that UCITS are allowed to invest 100% of their assets in other UCITS and a maximum of 30% in non-UCITS that are subject to equivalent supervision and investor protection. It will depend on the particular non-UCITS and the home Member States whether or not a non-UCITS will be eligible for UCITS to invest. Article 50(1)(e)(ii) of the UCITS Directive only provides that the level of investor protection should in particular be equivalent to the UCITS rules related to asset-segregation, borrowing, lending, and uncovered sales of transferable securities and money market instruments.<sup>39</sup>

Furthermore, as a general rule, UCITS are not allowed to invest more than 10% of their assets in transferable securities or money market instruments other than those referred to in Article 50(1) of the UCITS Directive ('trash bucket').<sup>40</sup> Another investment restriction worth noting is the restriction for UCITS to invest in psychical commodities or real estate. UCITS may not acquire precious metals or certificates representing them and may only acquire movable or immovable property which is essential for the direct pursuit of their business, i.e., only for own use (not investment purposes).<sup>41</sup> They can thus not directly invest in real estate. Such investments would however also be not suitable for UCITS due to their open-end nature, which requires a liquid portfolio. It is very difficult to provide timely liquidity from investments in real estate.

Lastly, the principle of risk spreading encompasses borrowing controls. Under the UCITS Directive, UCITS may borrow to 10% of their total net assets (including the borrowed amount) provided that the borrowing is: (a) on a temporary basis (i.e., within a specific time limit) or (b) in case it concerns the acquisition of immovable property that is essential for the direct pursuit of its business and the home Member States allows the UCITS to do so.<sup>42</sup> Since the Commission recommends that the overall risk exposure related to the use of derivatives may not exceed 100% of the UCITS' NAV (see above), the total risk exposure of a UCITS (including both leverage through

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38. Articles 50(1)(e) and 55(1) and (2) of the UCITS Directive. According to ESMA, non-UCITS that do not fulfil all of the conditions listed in the foregoing Article 50(1)(e) of the UCITS Directive do not constitute UCITS eligible investments under Article 50(2)(a) of the UCITS Directive, which requires UCITS to invest no more than 10% of their assets in other transferable assets or money market instruments that those referred to in Article (1)(e). Thus, UCITS may only invest in shares of other funds as defined in Article 50(1)(e) of the UCITS Directive. See ESMA's Opinion on Article 50(2)(a) of Directive 2009/65/EC, 2012/721, 20 Nov. 2012.

39. The non-UCITS in which the UCITS invests must also publish a half-yearly and annual report. See Article 50(1)(e)(iii) of the UCITS Directive.

40. Including unlisted securities and money market instruments.

41. Article 50(2)(b) and (3) of the UCITS Directive.

42. Article 83(2) of the UCITS Directive.

derivatives and borrowing by temporary means), should consequently not exceed 210% of the NAV on a permanent basis.<sup>43</sup> However, when a Member State has authorized UCITS to borrow money under both options, the total amount borrowed should not exceed 15% of the total assets of the UCITS.<sup>44</sup>

### 3.2.3 Authorization Requirements

The UCITS Directive establishes common authorization requirements which UCITS must comply with before they receive authorization from their home Member State to be allowed to pursue activities in the EU. These requirements are reflected in Article 5(4) of the UCITS Directive. This article firstly refers to number of standards set out in the directive applying to the business of the UCITS in case it is structured in the corporate form (i.e., an investment company with variable or fixed capital). Secondly, it refers to standards applying to UCITS that are structured in the contractual form (i.e., trusts or other contractual funds). In such a case, it requires the home Member State to approve the management company of the UCITS in case it complies with several operational and capital requirements of the UCITS Directive.

With respect to self-managed UCITS, it is referred to Article 29(1) of the UCITS Directive requiring that the UCITS must have at least EUR 300,000 initial capital. In addition, the self-managed UCITS must submit a programme of activity to its home Member State which sets out, at least, the organizational structure of the fund. The programme of activity furthermore generally requires the UCITS to submit a number of documents to satisfy its home Member State that, on an ongoing basis, it will be able to comply with the operational and governance requirements of the UCITS Directive. This typically includes the legal form of the UCITS, its draft articles of association, a description of outsourcing arrangements, policies on conflicts of interest and code of conduct, name of external auditor, investment policy and strategies, and a description of the risk management and remuneration policies in place.

Furthermore, the UCITS' directors must be of sufficiently good repute and be sufficiently experienced in relation to the type of business carried out by the UCITS. At least two directors must decide on matters related to the conduct of the UCITS' business and in case a 'close link' exists between the UCITS and other natural or legal persons, including directors, authorization may be granted only if this link does not prevent effective supervision.<sup>45</sup> Lastly, rules on management delegation and the depositary must be complied with.<sup>46</sup>

In case the UCITS does not meet these requirements, its authorization will be refused by its home Member State. Member States must furthermore draw up prudential rules that such a UCITS, once authorized, must comply with, including rules on

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43. Commission Recommendation 2004/383/EC on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS), 26.

44. Article 83(2)(b) of the UCITS Directive.

45. Article 29(1)(a), (b) and (c) of the UCITS Directive.

46. Articles 13, 29, 30, and 32–36 of the UCITS Directive. See on these rules also sections 2.3.1[B] & 2.3.3[A].

record-keeping, accounting procedures and that the assets of the UCITS are invested in accordance with the instrument of incorporation and the laws currently in force.<sup>47</sup> In this respect, Article 14 of the UCITS Directive gives a list of principles which should serve as the measure for rules of conduct for UCITS. Special emphasis is put on the idea of the UCITS acting honestly, fairly, and with due skill, care and diligence. See on these conduct of business rules section 3.8.

The authorization requirements for UCITS management companies are laid down in Article 7 of the UCITS Directive. It provides that the initial capital of a management company must be a minimum of EUR 125,000. Other than self-managed UCITS, UCITS management companies must maintain an additional amount of own funds equal to 0.02% of the value in excess of EUR 250 million. However, there is a maximum limit of 'own funds set'<sup>48</sup> at EUR 10 million and the minimum additional own funds must never be lower than one quarter of the management company's preceding year fixed overheads.<sup>49</sup> UCITS management companies may be exempted from providing up to 50% of the additional amount of own funds if they have a guarantee from a credit institution or insurance undertaking.<sup>50</sup>

Similar to the authorization rules for self-managed UCITS, the conduct of the business of a UCITS management company must be decided by at least two persons who are considered by the competent home Member State of the management company to be experienced and to possess sufficient good repute.<sup>51</sup> Also, similar provisions apply related to other business aspects, including the programme of activity, the possibility to refuse authorization in case of connections to a natural or legal third party which are deemed to prevent effective supervision, rules related to the depositary, the delegation of management activities, and the obligation of Member States to draw up rules addressing prudential issues and the conduct of business rules set out in the directive.<sup>52</sup> Other requirements relate to the head and registered office of the management company, the approval of qualifying shareholders, and investments in UCITS that are managed by the management company.<sup>53</sup>

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47. Article 31 of the UCITS Directive.

48. 'Own funds' includes the notion of 'initial capital' and adds in particular (1) 'revaluation reserves', (2) 'value adjustments', (3) 'other items' within the meaning of Article 63 of Directive 2006/48/EC, and (4) fixed-term cumulative preferential shares and subordinated loan capital as referred to in Article 64(3) of Directive 2006/48/EC. See Article 2(1)(l) of the UCITS Directive (referring to Articles 56–67 of Directive 2006/48/EC).

49. Article 7(1)(a)(i) and (iii) of the UCITS Directive and Article 21 of Directive 2006/49/EC of the European Parliament and of the Council of 14 Jun. 2006 on the capital adequacy of investment firms and credit institutions (recast), OJ L 177, 201.

50. Article 7(1)(d) of the UCITS Directive.

51. Article 7(1)(b) of the UCITS Directive.

52. *Ibid.* and Articles 7(1)(c), (2), 12(1), 13, 14 and 22–26 of the UCITS Directive. See on the rules related to the delegation of management functions and the depositary also sections 2.3.1[B] & 2.3.3[B].

53. Articles 7(1)(d), 8 and 12(2) of the UCITS Directive.

### 3.3 AIF

Before the adoption of the AIFM Directive, AIFs, or non-UCITS, were not subject to specific EU legislation. AIFs were only regulated by national law. Furthermore, many managers of AIFs, in particular managers of private equity and hedge funds, were not required to license for portfolio management and/or investment advice under the MiFID due to the fact that they were generally domiciled in non-EU jurisdictions.<sup>54</sup> Additionally, the offering and sale of the shares of the AIFs were often exempt from the requirements of the Prospectus Directive as offers of AIF shares are generally addressed to only qualified investors and/or a limited number of investors.

With the adoption of the AIFM Directive, a harmonized framework for regulating AIFs is provided. Other than the UCITS Directive, which is intended to be an optional framework, the objective of the AIFM Directive is to impose mandatory rules on AIFMs that operate within the EU.<sup>55</sup> EU AIFMs will benefit from a ‘passport’ enabling them to market EU AIFs in the EU. Non-EU AIFMs can market AIF shares in the EU with a passport from November 2015 at the latest, in case of non-EU AIFMs or AIFs established in Guernsey, Jersey or Switzerland, or within three months after a positive advice from ESMA.<sup>56</sup> Before that date, such AIFMs will have to use the national private placement regimes of each Member State in which they wish to market these shares, provided that these regimes comply with Article 36 or 42 of the AIFM Directive. However, as stated before, for the purpose of this research, it is assumed that the provisions of the AIFM Directive related to the EU passport for non-EU AIFs and AIFMs have come into effect.

Pursuant to Article 31(1) of the directive, an authorized EU AIFM may market shares of an EU AIF to professional investors as defined in Annex II to the MiFID 2 in its home Member State, either by providing cross-border marketing services or by means of a branch, provided that the notification requirements for such AIFMs are met (see section 2.2.3[A]). The notification requirements are set out in Article 31(2) and Annex III, which requires the AIFM to provide the competent authorities in its home Member State with several details of each EU AIF that it intends to market.<sup>57</sup> Non-EU AIFMs that wish to market EU AIFs under an EU passport must comply with the rules

54. The original MiFID did not provide a harmonized approach non-EU firms providing investment services to or for EU clients but left it to Member States to impose limits on such services, subject to the general requirement under EU law not to grant a non-EU firm more favourable treatment than an EU firm. Under the MiFID 2, however, non-EU AIFM that wish to provide MiFID investment services, which include portfolio management and investment advice, are covered by the directive. See Article 39 of MiFID 2.

55. Recital 2 of the preamble to the AIFM Directive (“This Directive (...) aims at establishing common requirements governing the authorisation and supervision of AIFMs in order to provide a coherent approach to the related risks and their impact on investors and markets in the Union”) and Zetsche, *The Alternative Investment Fund Manager Directive*, 85–86.

56. See section 2.2.3[A]. Thus far, ESMA has delivered a positive advice to extent the AIFM passport to Guernsey, Jersey and Switzerland. *Ibid.*

57. Article 32 of the AIFM Directive and Annex IV to the AIFM Directive. This information includes the rules or instrument of incorporation of the AIF, a description of, or any information on, the AIF, and any additional disclosures to investors. In case the EU AIFM wishes to market EU AIF shares in other Member States than its home Member State, it must meet similar requirements.

set out in Articles 37 and 39 of the AIFM Directive. Since such AIFMs are established in a non-EU Member State, Article 37(1) of the directive requires that they must receive authorization to market their shares under the passport by their 'Member State of reference'.<sup>58</sup> Similar to authorized EU AIFMs, it must submit a notification file (to its Member State of reference), which includes relevant information on each AIF and the information provided to investors.<sup>59</sup> In addition, the competent authorities of the Member State of reference are required to inform ESMA and the competent authorities of the AIF that the AIFM may start marketing.<sup>60</sup>

In case of an EU AIFM marketing non-EU AIFs in the EU, Article 35(2) of the directive provides that they may only do so if they comply with all the requirements of the AIFM Directive, except for the rules applying to the marketing of EU AIFs by EU AIFMs, if certain additional conditions are met.<sup>61</sup> The notification procedure of the AIFM is similar to the procedure applicable to EU AIFMs marketing EU AIFs.<sup>62</sup> Additionally, as is also the case for the Member State of reference of the non-EU AIFM marketing EU AIFs via a passport, the home Member State of the AIFM must inform ESMA in case the AIFM may start marketing the non-AIFs shares.<sup>63</sup>

Lastly, non-EU AIFMs marketing EU AIFs must request authorization and file notification with their Member States of reference.<sup>64</sup> These AIFMs are not subject to a provision of the AIFM Directive in case this provision is incompatible with national law the AIFM or AIF has to comply with.<sup>65</sup> They are furthermore subject to equivalent conditions on these matters applying to EU AIFMs described above, provided that with instead of the AIFM's home Member State, it is referred to the AIFM's Member State of reference.<sup>66</sup> The notification procedure is in line with the notification procedure that

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58. In general, the Member State of reference will be the Member State in which the largest part of the AIFM's activities subject to the directive takes place, although the AIFM may often also choose for the Member State in which the AIF it intends to market is registered (if such is the case). See Article 37(4) of the AIFM Directive.

59. Article 39(2) and (4) of the AIFM Directive and Annex III and IV to the AIFM Directive.

60. Article 39(3) and (6) of the AIFM Directive.

61. These conditions are: (1) there must be satisfactory cooperation agreements in place between the competent authorities of the AIFM's home Member State and the supervisory authorities of the country of establishment of the non-EU AIF, (2) the country of establishment of the non-EU AIF is not on the list of Non-Cooperative Countries and Territories by the Financial Action Task Force on anti-money laundering and terrorist financing, and (3) the country of establishment of the non-EU AIF has signed a OECD compliant tax treaty with the relevant AIFM's home Member State and with any other Member State in which it is intended that the non-EU AIF will be marketed. See Article 35(2)(a)-(c) of the AIFM Directive.

62. Article 35(4) of the AIFM Directive.

63. Article 35(7) of the AIFM Directive.

64. Article 37(1) of the AIFM Directive.

65. Article 37(2) of the AIFM Directive. Non-EU AIFM must provide additional information regarding its assessment as to which Member State it considers to be its Member State of reference, the name of the legal representative of the AIFM and the place where it is established, and the provisions of the directive that the AIFM cannot comply with due to incompatibility of national law. In case of the latter, the AIFM must also provide written evidence based on ESMA standards that its national law provides for rules equivalent to the rules of the directive for which compliance is impossible, offering the same level of investor protection. Article 37(8)(a) of the AIFM Directive.

66. Article 40(2) of the AIFM Directive.

applies to EU AIFMs.<sup>67</sup> Furthermore, similar to non-EU AIFMs marketing EU AIFs, the competent authorities of the Member State of reference of the AIFM is required to inform ESMA on the marketing approval of the AIF shares.<sup>68</sup>

AIFs are defined in Article 4(1) of the AIFM Directive as ‘collective investment undertakings (...), which: (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorization pursuant to Article 5 of Directive 2009/65/EC [the UCITS Directive]’. Article 4(2) of the directive gives the definition of AIFMs, which are ‘legal persons whose regular business is managing one or more AIFs’. In sum, there are three requirements that a fund has to meet in order to fall under the definition of an AIF and for the directive to apply to its AIFM: (1) it must raise capital from a number of investors, (2) in accordance with a pre-defined investment policy, and (3) does not require authorization under the UCITS Directive. With respect to the first two criteria, it can be referred to section 2.2.1 about funds in general. With respect to the last criterion, it can be referred to what is described above about UCITS.

Similar to UCITS management companies and self-managed UCITS, AIFMs must receive prior authorization of their home Member State (or Member State of reference in case of a non-EU AIFM) in order to manage and/or market AIF shares in the EU via a passport.<sup>69</sup> The qualification of being an AIF is thus worthless without the actual authorization to provide management service or the cross-border marketing of AIF shares in the EU. Therefore, although they are technically not criteria to fall under the scope of the directive, the authorization requirements for AIFMs will be discussed below (section 3.3.1). In addition, as mentioned, the AIFM Directive is intended to be a mandatory framework for all non-UCITS. Therefore, other than is the case under the UCITS Directive, there are a number of exemptions to the directive to prevent application. These key exemptions to the scope of the AIFM Directive will also be set out below (section 3.3.2).

### 3.3.1 Authorization Requirements

An AIFM that cannot make use of an exemption from the AIFM Directive will need to obtain authorization from its home Member State, or in case of a non-EU AIFM, its Member State of reference. Article 8(1) of the AIFM Directive requires that the competent authorities of the home Member State of the AIFM may only grant authorization in case: (1) they are satisfied that the AIFM will meet the conditions of the directive, (2) the AIFM complies with Article 9 of the directive, (3) there are at least two persons that conduct the business of the AIFM and they are of sufficiently good repute and sufficiently experienced considering the investment strategies pursued by the AIFM, (4) the investors of the AIFM that have qualifying holdings are suitably taking into account the sound and prudent management of the AIFM, and (5) the head office and registered office of the AIFM are located in the same Member State. With

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67. Article 40(4) of the AIFM Directive.

68. Article 40(7) of the AIFM Directive.

69. Articles 6(1), 31(1), 32(1), 33(1) 35(1), 37(1), 39(1) and 40(1) of the AIFM Directive.

respect to non-EU AIFMs, the latter requirement logically does not apply as well as the requirements in the directive related to the marketing of EU AIF shares in the EU by EU AIFMs and rules that are 'incompatible with compliance with the law to which the non-EU AIFM and/or the non-EU AIF marketed in the Union is subject'.<sup>70</sup>

Similar to UCITS management companies, authorization must be refused in case close links exist between the AIFM and other natural or legal persons which prevent the effective supervision of the AIFM.<sup>71</sup> Additionally, it can be noted that Member States may restrict the scope of the authorization, in particular as regards the investment strategies of AIFs the AIFM is allowed to manage.<sup>72</sup> Since most AIFMs focus on one or a limited number of investment strategies, the license granted by the competent authority of the home Member State will generally be restricted to those strategies for which the AIFM has skilled and experienced personnel.<sup>73</sup> Other restrictions that may be imposed include restrictions on the services that an AIFM may perform, such as administration services and asset-related services, in case it does not have adequate resources for these services.<sup>74</sup>

The authorization rules of EU AIFMs are to a large extent similar to those applying to UCITS management companies. So AIFMs must provide information about their programme of activity setting. In addition, similar provisions apply related to the four eyes principle on business decisions, the possibility to refuse authorization in case of connections to a natural or legal third party which are deemed to prevent effective supervision, the head and registered office the AIFM, depositary arrangements, and the delegation of management functions.<sup>75</sup> The AIFM must also disclose its remuneration policies and practices and comply with the restrictions on remuneration.<sup>76</sup> In addition, they must provide information on their investment strategies, the AIFM's policy on leverage, provision of the rules or instruments of incorporation of each AIF, the identity of the master AIF, if any of the AIFs are feeder funds, risk profile and other characteristics of the AIFs, including whether they are or will be established in the EU or a third country, and various other disclosures to investors referred to in the AIFM Directive.<sup>77</sup> Given that the AIFM Directive does not regulate AIFs, but only AIFMs, this information provides the competent authority with the information needed to assess the risks and the risk-adjusted return profiles of the AIFs. While UCITS are not required by the UCITS Directive to provide this information to obtain an authorization, they will generally be required to provide similar information in their 'programme of activity' by national law as part of the application forms of their home Member States.

In addition to these information requirements, AIFMs are required to meet the capital requirements set out in Article 9 of the AIFM Directive in order to be granted a

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70. Article 37(2)(a) and (8)(d) of the AIFM Directive.

71. Article 8(3)(a) of the AIFM Directive.

72. Article 8(4) of the AIFM Directive.

73. Zetsche, *The Alternative Investment Fund Manager Directive*, 178.

74. *Ibid.*, 178–179. Zetsche notes that in such cases, the AIFM may delegate these functions to a third party, although it would still be required to supervise the third party via its depositary.

75. Article 7(2)(a), (b), (c), (e) and 8(1)(c), (d), (e) and (3) of the AIFM Directive.

76. Article 7(2)(d) of the AIFM Directive. UCITS are also subject to remuneration restrictions. See section 2.5.4.

77. Article 7(3) of the AIFM Directive.

license.<sup>78</sup> The capital requirements that an AIFM must hold differ depending on whether the AIFM is appointed as an external manager of AIFs or is an internally managed AIF. If the AIFM is an external manager of AIFs, it is required to have an initial capital of at least EUR 125,000. Similar to UCITS management companies, if the value of the portfolios managed by the AIFM exceeds EUR 250 million, the AIFM must provide an additional amount of own funds equal to 0.02% of the value in excess of EUR 250 million, with a limit of EUR 10 million. These own funds must be invested in liquid assets or assets readily convertible to cash in the short term and shall not include speculative positions.<sup>79</sup> The minimum additional own funds must never be lower than one quarter of the AIFM's preceding year fixed overheads.<sup>80</sup> Member States may authorize AIFM to not provide up to 50% of the additional amount of own funds in case they have a guarantee from a credit institution or insurance undertaking.<sup>81</sup> Internally managed AIFs are required to have an initial capital of at least EUR 300,000.<sup>82</sup>

Other than UCITS, AIFMs must either have professional indemnity insurance or have additional own funds appropriate to cover risks arising from professional negligence.<sup>83</sup> The liability of the AIFM should not be affected by delegation or sub-delegation and the AIFM should provide adequate coverage for professional risks related to such third parties for whom it is legally liable.<sup>84</sup> The professional liability risks envisaged by the Commission that should be covered include, but are not limited to, risks of losses arising from negligence in relation to business disruption, system failures and process management, and those in relation to investors, products and business practices. This would include the loss of title documents evidencing ownership, misrepresentations made by the AIFM or its staff resulting in a breach of the conduct of business rules, failures to prevent fraudulent or malicious acts by the AIFM's staff or third parties for whom the AIFM has vicarious liability, and the improper valuation of assets and calculation of share prices.<sup>85</sup>

If the AIFM chooses to cover professional liability risk through additional funds, it must hold at least 0.01% of the value of its assets under management. A Member State may however set a lower standard if the AIFM can demonstrate that liability risk is adequately covered or a higher standard if the competent authority believes the existing own funds held by the AIFM are not sufficient to cover the risks.<sup>86</sup> In addition to these quantitative requirements, the AIFM must also implement effective internal operational risk management policies and procedures in order to identify, measure,

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78. This article does not apply when the AIFM is authorized as a management company under the UCITS Directive. See Article 9(10) of the AIFM Directive.

79. Article 9(8) of the AIFM Directive. In its Q&A on the AIFM Directive, the Commission stated that Member States may develop principle based criteria to specify what should be considered as liquid or readily convertible to cash, but urges ESMA to develop a common approach among Member States on this issue. See Q&A on the AIFM Directive, ID 1153, Own Funds.

80. Article 9(5) of the AIFM Directive and Article 21 of Directive 2006/49/EC.

81. Article 9(6) of the AIFM Directive.

82. Article 9(1) of the AIFM Directive.

83. Article 9(7) of the AIFM Directive.

84. Article 75(a) of the Commission Delegated Regulation on AIFMs.

85. Article 12 of the Commission Delegated Regulation on AIFMs.

86. Article 14(2), (4) and (5) of the Commission Delegated Regulation on AIFMs.

manage and monitor appropriately operational risks including professional liability risks.<sup>87</sup> Operational risk exposures and loss experience must be monitored by the AIFM on an ongoing basis, with operational risk management policies and procedures and measurement systems to be subject to regular review, at least on an annual basis.<sup>88</sup>

### 3.3.2 Exemptions and Exclusions

The AIFM Directive provides for a number of exemptions and exclusions. The most commonly used exemptions include the exemption for non-EU AIFs and AIFMs, the intragroup exemption, the ‘de minimis exemption’, and the exclusions for holding companies, family offices, joint ventures and insurance contracts, and other entities that cannot be considered to be AIFs. Firstly, as mentioned (see section 3.3), non-EU AIFMs marketing AIFs and EU/non-EU AIFMs marketing non-EU AIFs in the EU are currently not subject to the full directive. As a result, they will not have access to the EU passport, although certain non-EU AIFs (established in Guernsey, Jersey and Switzerland), will be able to use the passport from November 2015 at the latest. However, since it is likely that the passport will be extended to the marketing of AIFs by non-EU AIFMs and non-EU AIFs by EU AIFMs (see section 2.2.3[A]), this exclusion will not be discussed separately below. Secondly, in addition to these exemptions, it can be noted that the AIFM Directive includes two grandfathering provisions for AIFMs managing existing AIFs of the closed-end type that have been offered pursuant to a private placement. If such AIFs: (1) do not make any additional investments after 22 July 2013, or (2) closed their subscription period for investors prior to 21 July 2011 and if their term expires at the latest by 22 July 2016, the relevant AIFM may, however, continue to manage such AIFs without needing an authorization under the AIFM Directive.<sup>89</sup> Thirdly, AIFMs that market shares of AIFs under a prospectus set up in accordance with the Prospectus Directive are not subject to Articles 31, 32 and 33 of the AIFM Directive and thus may continue to be marketed to the public on the basis of that prospectus, as long as the prospectus is valid.<sup>90</sup> These grandfathering and transitional provisions are in no need for further explanation. Therefore, below, the following key exemptions to the directive are discussed in more detail: [A] the intragroup exemption, [B] the de minimis exemption, and [C] exclusions (including, among others, holding companies and family offices).

#### *[A] Intragroup Exemption*

Pursuant to Article 3(1) of the AIFM Directive, the directive does not apply to AIFMs that manage AIFs whose only investors are the AIFM or the parent undertakings, subsidiaries or other subsidiaries of the parent undertakings of the AIFM, provided that none of those investors itself is an AIF. This exemption is also referred to as the

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87. Article 13 of the Commission Delegated Regulation on AIFMs.

88. Article 13(4) of the Commission Delegated Regulation on AIFMs.

89. Article 61(3) and (4) of the AIFM Directive.

90. Article 61(2) of the AIFM Directive.

‘intragroup exemption’ as it aims at excluding group companies with no external investors. The definition of ‘parent undertaking’ and ‘subsidiary’ follows those used for the purposes of consolidating accounts on a group basis.<sup>91</sup> Where a financial transaction or (delegation) arrangement falls within the intragroup exemption, that transaction or arrangement will be a full derogation in the sense that none of the requirements of the AIFM Directive will apply to the relevant entity.

The effect of this exemption that the relevant AIFM will be out of the scope of the AIFM Directive with respect to these activities. In cases where the AIFM is a member of a group and subject to the AIFM Directive due to its other activities, its conflict of interest policy must also take into account any circumstances of which the AIFM is or should be aware which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.<sup>92</sup> The policy must include reference to the activities carried out by or on behalf of the AIFM, including activities carried out by a delegate, subdelegate, external valuer or counterparty, identifying the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of the AIF or its investors, and must specify any procedures to be followed and measures to be adopted in order to prevent, manage and monitor such conflicts.<sup>93</sup>

### **[B] De Minimis Exemption**

As stated in Article 3(2) of the AIFM Directive, an exemption applies to certain small AIFMs. This exception refers to the business volume of AIFMs and is also known as the ‘de minimis exemption’. It is included in the directive to prevent unnecessary administrative burden is imposed on AIFM that the Commission assumes to not pose relevant risks to financial stability and market efficiency.<sup>94</sup> The de minimis exemption, although referred to as such, it not a real exemption as it does not fully exclude AIFMs from the scope of the directive, but provides a lighter (‘minimis’) regime for AIFMs. It applies to AIFMs that manage portfolios of AIFs which in aggregate do not exceed: (a) EUR 100 million, or (b) EUR 500 when the AIFs are unleveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF. In cases where the portfolio of AIFs of an AIFM combines both (a) and (b), the AIFM must aggregate the portfolios of all AIFs and the threshold of EUR 100 million should be applied in determining whether the AIFM is fully within scope.<sup>95</sup>

When the ‘exemption’ applies, the AIFM is not subject to a license requirement but only to an obligation to register and thereby only ‘limited’ reporting obligations apply. Such AIFMs must provide information on its identity, the AIFs managed and their investment strategies to the competent authorities. The AIFM will furthermore

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91. Article 3(ae) and (ak) of the AIFM Directive.

92. Article 31(1) of the Commission Delegated Regulation on AIFMs.

93. Article 31(2) of the Commission Delegated Regulation on AIFMs.

94. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 48 and 55.

95. Article 2(1)(c) of the Commission Delegated Regulation on AIFMs.

need to report on a regular basis on the main instruments traded, the principal exposures and most important concentrations of AIFs managed.<sup>96</sup> The rationale behind these rules is, although the activities of the AIFM concerned are unlikely to have individually significant consequences for financial stability, it could be possible that in aggregate their activities give rise to systemic risk. In case the exempted AIFM no longer falls under the *de minimis* exemption, it must notify its competent authority and apply for a full authorization.<sup>97</sup>

AIFMs that use the *de minimis* exemption cannot market their shares in the EU via the AIFM passport, unless they opt-in to the AIFM Directive. This possibility is set out in Article 3(4) of the AIFM Directive, which provides that the particular AIFM may voluntarily choose to apply to the stricter rules requiring a license as a result of which it may benefit from the passport rights provided under the directive and becomes subject to all the provisions of the directive. In addition, venture funds and social entrepreneurship funds that fall under the EuVCF or EuSEF Regulation are provided with an EU passport under this regulation in case their assets under management fall below the EUR 500 million threshold, subject to some reducing requirements for their AIFMs.<sup>98</sup> See on the EuVCF Regulation also section 2.6.6[B].

In order to qualify for the *de minimis* exemption, the total value of assets under management of the AIFM must be calculated. The Commission has adopted rules on how this should be done in its Delegated Regulation on AIFMs. These rules determine, among other things, that AIFMs must calculate their assets under management on at least an annual basis (except for closed-ended AIFs) using the latest available asset values, on a threshold calculation date determined by the AIFM and applied in a consistent manner.<sup>99</sup> Exempted from the calculation are all UCITS portfolios, investments of AIFs in other AIFs that are managed by the same AIFM, and investments of AIFs in compartments of that AIF.<sup>100</sup> In cases where the (exempted) AIFM has substantial leveraged portfolios, it must disclose this exposure to the competent authorities of its home Member State.<sup>101</sup> Registered AIFMs must also disclose their total amount of leverage calculated in accordance with these two methods as part of the AIF's periodic reporting to investors.<sup>102</sup>

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96. Article 3(3)(a)-(d) of the AIFM Directive. Member States may however impose stricter provisions to these AIFMs. See Article 3(3) of the AIFM Directive.

97. Article 3(3)(e) of the AIFM Directive. However, breaches of the threshold that are of a temporary nature are allowed. A situation is no longer considered to be temporarily in case it is likely to continue for a period in excess of three months. See Article 4(4) of the Commission Delegated Regulation on AIFMs.

98. See for the definitions of venture capital and social entrepreneurship funds that are subject to these regulations, Article 3(b) of the EuVCF Regulation and Article 3(b) of the EuSEF Regulation.

99. Article 2(6) of the Commission Delegated Regulation on AIFMs.

100. Article 2(2), (4), and (5) of the Commission Delegated Regulation on AIFMs.

101. Articles 24(4) of the AIFM Directive and 110(5) of the Commission Delegated Regulation on AIFMs. An AIFM is considered to be employing substantial leverage when the exposure of an AIF as calculated by the commitment method exceeds three times its NAV. See Article 111(1) of the Commission Delegated Regulation on AIFMs.

102. Articles 23(5) of the AIFM Directive and 109(2)(a) and (3) of the Commission Delegated Regulation on AIFMs.

It is difficult to define or quantify the exact impact of the *de minimis* exemption. In the case of hedge funds, the Commission stated that *de minimis* rule of EUR 100 million would exempt 80% of the hedge fund managers, but would still cover about 70% of the total net assets under management of the market. The EUR 500 million however would cover about half of the total hedge fund industry's net assets, but only less than 10% of the managers'.<sup>103</sup> Since most hedge funds will be considered to be leveraged, the EUR 100-threshold will most likely apply, as a result of which most hedge fund managers will fall under the full scope of the directive. The Commission has noted that the use of a threshold may give rise to abuse in order to circumvent the full directive from applying.<sup>104</sup>

Such abuse could for example be done through the use of an FoF structure in which a non-EU AIF offering shares to EU investors invests solely in other, leveraged AIFs and all funds have the same manager. The non-EU AIF may exempt from its assets calculation the investments in the other AIFs, as a result of which it will be considered unleveraged for the purpose of the *de minimis* exemption. The other AIFs are exempt from application of the AIFM directive if they have only issued shares to the non-EU AIF. Since the non-EU AIF does not qualify as an EU investor, these funds fall outside the scope of the directive. As a result, the AIFM of the non-EU AIF would not be required to comply with the AIFM Directive. However, it can be questioned whether such a structure will be allowed by Member States as recital 9 of the AIFM Directive provides that 'Member States should (...) ensure that investment firms established in a third country that, pursuant to the relevant national law, can provide investment services in respect of AIFs also fall within the scope of [the AIFM Directive]' and that national law implementing the directive 'should never amount to a *de facto* circumvention of this Directive by means of turning the AIFM into a letter-box entity, irrespective of whether the AIFM is established in the Union or in a third country'.<sup>105</sup>

In any case, it is not expected that a large part of the AIFM industry in terms of assets under management will be able to take advantage of the threshold amounts considering the small *de minimis* limits set out within the AIFM Directive.<sup>106</sup> However,

103. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 48. Furthermore, the *de minimis* rule would exempt only between 5% and 25% of the 80% of hedge funds domiciled outside the EU, and just over 20% of the estimated 66% of private equity firms outside the EU. See European Parliament's Committee on Economic and Monetary Affairs, Ex-ante evaluation of the proposed Alternative Investment Managers Directive, IP/A/ECON/NT/2009\_03, Feb. 2011, 11.

104. *Ibid.*, 51. The Commission however states that 'this has to be weighed against the burden imposed on the AIFM covered'. *Ibid.*

105. It will thus depend on the applicable national law and the supervision exercised by the national financial supervisory authorities whether or not the AIFM will need to comply with the AIFM Directive. However, Article 82 of the Commission Delegated Regulation on AIFMs provided for a number of circumstances under which the AIFM is considered to be a 'letter-box entity' and therefore is no longer considered to be the manager of the AIF, including the situation when the AIFM no longer has the power to take key decisions and has delegated the performance of investment management functions to an extent that exceeds by a substantial margin the management functions performed by the AIFM itself. This article does not include the situation in which the FoF structure is used to circumvent application of the AIFM Directive.

106. PwC, *The AIFM: Getting Authorised – AIFMD Newsbrief* 6 (February 2013). The news brief can be found at <http://www.pwc.lu/>.

many managers with a small asset portfolio will however fall under the exemption. AIFMs that are exempt on the basis of the de minimis exemption must nonetheless register with the relevant competent authorities of their home Member State and provide for certain initial information on, among other things, their investment strategies, and ongoing information (at least annually) on the main instruments in which they are trading, the principal exposures and the most important concentrations of the AIFs they manage in order to enable the authorities to effectively monitor systemic risk.<sup>107</sup> Since these ‘exempted’ AIFMs do not benefit from the EU AIFM passport, the question can be raised whether the advantages outweigh the costs of using the de minimis exemption.<sup>108</sup> It may therefore be more beneficial for some of these AIFMs to opt-in to the full directive. Furthermore, Member States may impose additional (stricter) requirements and use different and complex registration forms for the registration of these AIFMs, which may further increase the costs and reduce the advantage of this exemption.

### [C] Exclusions

Besides the exemptions described above, the AIFM directive excludes a number of entities. These entities are not considered AIFs and therefore fall outside the scope of the directive. To this end, in the first place, Article 2(3) of the AIFM Directive sums up the following entities that the directive does not apply to:

- (a) holding companies;
- (b) institutions covered by the Directive on the activities and supervision of Institutions for Occupational Retirement Provision (IORP Directive), or pension funds;<sup>109</sup>
- (c) supranational institutions, such as the World Bank, IMF, ECB, and other supranational institutions and similar international organizations;<sup>110</sup>

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107. In the Commission Delegated Regulation on AIFMs, these information requirements are further specified. So are exempted AIFMs required to provide, among other things, a break-down of financial instruments and other assets in which it is trading, including the AIF’s investment strategies and their geographical and sectoral investment focus. See Article 110(1)(a) of the Commission Delegated Regulation on AIFMs.

108. See also Zetsche, *The Alternative Investment Fund Manager Directive*, 67 (stating that ‘[t]his heavy handed approach takes a lot from the proportionality principle to which the legislature often referred when discussing the AIFM (Level 1) Directive’).

109. Directive 2003/41/EC of the European Parliament and of the Council of 3 Jun. 2003 on the activities and supervision of institutions for occupational retirement provision, OJ L 235, 10 (IORP Directive). The IORP Directive defines an Institution for Occupational Retirement (IORP) as ‘an institution, irrespective of its legal form, operating on a funded basis, established separately from any sponsoring undertaking or trade for the purpose of providing retirement benefits in the context of an occupational activity. See Article 6(a) of the IORP Directive. The IORP thus regulates occupational pension funds.

110. This exemption applies in so far the AIFs act in the public interest, which may, for example, include the temporarily adoption of AIF management in order to stabilize the financial markets. See Zetsche, *The Alternative Investment Fund Manager Directive*, 57.

- (d) national central banks;<sup>111</sup>
- (e) national, regional and local governments and bodies or other institutions which manage funds supporting social security and pensions systems;<sup>112</sup>
- (f) employee participation or saving schemes;<sup>113</sup>
- (g) Securitization Special Purpose Entities (SSPEs).<sup>114</sup>

### *Holding Companies*

With respect to the above-mentioned list of exclusions, the exclusion for holding companies needs some further explanation. Holding companies are defined in the directive as companies which carry out a business strategy or strategies through its affiliates in order to contribute to its long-term value and, where a holding company is not listed on an EU stock exchange and operating for its own account, are not established for the main purpose of generating returns for its investors by means of divestment of its affiliates.<sup>115</sup> When looking at this definition, four criteria can be identified: (1) the holding of participations in affiliates, (2) the pursuit of one or more business strategies, (3) aimed at creating long-term value, and (4) being listed on an EU stock exchange and operating for its own account *or* not established for the primary purpose of obtaining return for investors by the disposal of its affiliates.

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111. *Ibid.*

112. The AIFM Directive is thus not applicable on social security and pension funds managed by government institutions. Sovereign wealth funds (i.e., a state-owned pool of money that invests in various financial assets) may fall under this exemption, but will often also be exempt from the AIFM Directive due to the fact that they do not raise capital from investors as they generally invest government budgetary surplus. *See also Zetsche, The Alternative Investment Fund Manager Directive*, 65.

113. This exclusion covers schemes in which an employee invests in securities of the employer or in a company in the employee's group (or derivatives in relation to them such as options) or other schemes (such as an employee carried interest or co-investment vehicles).

114. SPPEs are defined in the AIFM Directive entities which sole purpose is to carry on a securitization or securitizations within the meaning of Article 1(2) of Regulation 24/2009 of the ECB. The ECB defines 'securitization' as 'a transaction or scheme whereby an asset or pool of assets is transferred to an entity that is separate from the originator and is created for or serves the purpose of the securitisation and/or the credit risk of an asset or pool of assets, or part thereof, is transferred to the investors in the securities, securitisation fund units, other debt instruments and/or financial derivatives issued by an entity that is separate from the originator and is created for or serves the purpose of the securitization'. It can be noted that structured issues which are not credit-linked (e.g., debt securities linked to indices, commodities or equities), or structured issues where the transfer of credit risk could be viewed as accessory to the principal activity of the entity, or structured issues where there is no separation of the originator and issuer (possibly loan participation notes), may not fall within this definition. *See Joint Associations Committee on Retail Structured Products (JAC), Response to ESMA Consultation Paper – Guidelines on Key Concepts of the AIFMD (ESMA/2012/845) (the AIFMD Key Concepts Consultation)* 6 (29 Jun. 2104). The Commission notes that the securitization special purpose entities exemption should be interpreted narrowly and should not be used in order to circumvent the application of the AIFM Directive, but that further guidelines of ESMA may be feasible. *See Q&A on the AIFM Directive*, ID 1157, Scopes and exemptions. The JAC response can be found at ESMA's website: <http://www.esma.europa.eu/>.

115. Article 4(1)(o) of the AIFM Directive.

With respect to the first criterion, i.e., the holding of participations in affiliates, it is not clear if these participations should only include controlling stakes or whether non-controlling stakes, without exercising control, may also be considered. It should be considered that this could lead to different interpretations among Member States. The second criterion, i.e., the pursuit of one or more business strategies, refers to the difference between pursuing an investment strategy and a business strategy.<sup>116</sup> The third criterion provides that this business strategy must be intended at generating long-term value. The term 'long-term value' is not further defined and thus also leaves space for different interpretations by Member States. Private equity and venture capital funds may claim that they do just that. However, in addition to the aforementioned criterion, the fourth criterion relevant to these funds, i.e., self-governed listed funds, should also be met.<sup>117</sup>

In its Q&A, the Commission considers that the holding company exemption must be read in conjunction with recital 8 of the AIFM Directive which specifically mentions that managers of private equity whose shares are admitted to trading should not be excluded by definition as the criterion of being listed is not in itself sufficient. According to the Commission, a holding company is a separate legal entity that carries out the business of owning and holding equity shares of other companies without the intent to dispose of such shares. Such business is done on the own account of the holding company and not on behalf of a third party. All other operations apart from those related to the ownership of shares and assets are done via its subsidiaries, associated companies or participations. The Commission concludes that the exclusion of a holding company in Article 2(3)(a) was meant to exclude from the AIFMD large corporates such as Siemens or Shell.<sup>118</sup> Since private equity and venture capital funds generally intend to dispose of their shares after a certain holding period in order to gain a profit for their investors, they will not be able to use this exclusion based on the Commission's interpretation.

### *Family Offices*

In addition to the list of entities that are expressly excluded from the AIFM Directive in Article 2(3), other entities may be excluded from the directive on the basis of the preamble or another provision included in the AIFM Directive, including family offices. The 'family offices' exemption is also reflected in preamble to the directive, which states that 'family office vehicles which invest the private wealth of investors without raising external capital, should not be considered to be AIFs in accordance with this Directive'.<sup>119</sup> In this context, it can be noted that the directive may seem to be making

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116. See section 2.2.1.

117. Considering that these funds will generate return for their investors from the sales of shares, the second restriction of this criterion, i.e., not being established for the primary purpose of obtaining return for investors by the disposal of its affiliates, will not be available to them.

118. Q&A on the AIFM Directive, ID 1146, Scopes and exemptions.

119. *Ibid.*, 9-10, recital 7 of the preamble to the AIFM Directive and ESMA, Final report – Guidelines on key concepts of the AIFMD, 32 ('[W]hen capital is invested in an undertaking by a member

a distinction between internal and external capital, as it considers the absence of external capital indicative for whether or not a family office is an AIF.

In a similar way, in its 2012 discussion paper on key concepts of the AIFM Directive and types of AIFM, ESMA stated that a fund whose only investors are the manager and its ‘employees’ should not be an AIF as such investors are not ‘external investors’.<sup>120</sup> However, ESMA deleted this part from the text of its final Guidelines on key concepts of the AIFMD as ‘the exemption would have been against the Level 1 provisions, since the relationship of the investor with an undertaking should not define the existence of a fund’.<sup>121</sup>

### *Joint Ventures and Insurance Contracts*

According to recital 8 of the AIFM Directive, joint ventures and insurance contracts are also not subject to the AIFM Directive. While the directive thus clearly intends to exclude such structures from its scope, they are not included in the list of exclusions set out in Article 2(3). The Commission’s Q&A considers in this respect that recital 8 is a ‘floating’ recital with no legal effect. Therefore, joint ventures are not excluded per se but only to the extent they do not have the characteristics of an AIF or fall within the scope of an express exemption.<sup>122</sup> Joint ventures will generally not be AIFs because they cannot be considered to be collective investments undertakings under Article 4(1)(a) of the AIFM Directive due to the fact that the participating companies typically have day-to-day discretion or control over the activities of the joint venture.<sup>123</sup> However, as mentioned, this should be determined on a case-by-case basis by the Member States. With respect to insurance contracts, including life insurance funds, the same rule can, in my view, be applied. According to the Commission’s Q&A, ‘each situation should be assessed on its own merits in order to determine whether the criteria listed in Article 4(1)(a) are fulfilled or not, whereby substance should prevail over the formal denomination of the specific structure’.<sup>124</sup>

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of a pre-existing group, for the investment of whose private wealth the undertaking has been exclusively established, this is not likely to be within the scope of raising capital’).

120. ESMA, Discussion paper – Key concepts of the Alternative Investment Fund Managers Directive and types of AIFM, 52 (under 13(a) and (b)) (‘[W]hen capital is invested in an undertaking by a natural or legal person or body of persons who is (...): (a) a member of the governing body of that undertaking or the legal person managing that undertaking; [or] (b) an employee of the undertaking or of the legal person managing the undertaking whose professional activities have a material impact on the risk profiles of the undertakings they manage and into which he or she invests; (...) this is not likely to be within the scope of raising capital’).
121. ESMA, Final report – Guidelines on key concepts of the AIFMD, 13.
122. Q&A on the AIFM Directive, ID 1160, Scopes and exemptions.
123. Joint ventures can be defined as ‘a number of contractual relations formed to carry out one project and generally define a business agreement in which parties agree to develop a new entity and new assets by contributing equity. The parties exercise control over the enterprise and consequently share revenues, expenses and assets’. *Ibid.*
124. *Ibid.*

### *Other Non-collective Investment Undertakings*

Next to holding companies, family offices and joint ventures and insurance contracts, there is a 'catch all' provision for all other entities that cannot be qualified as undertakings for collective investments under Article 4(1)(a) of the AIFM Directive and are therefore not considered to be AIFs (and thus excluded from the AIFM Directive). ESMA's Guidelines on key concepts of the AIFMD explains when an entity is a 'collective investment undertaking' for the purpose of the AIFM Directive.<sup>125</sup> It provides for three cumulative criteria.

Firstly, an entity should not be carried on for a general commercial or industrial purpose, i.e., the purpose of pursuing a business strategy which includes running a predominantly commercial or industrial activity.<sup>126</sup> This criterion again intends to exclude ordinary companies from the AIFM Directive. In this context, it can be noted that real-estate funds may claim that they fall outside the scope of the AIFM Directive on the basis that they have a 'general commercial or industrial purpose', namely property development or property rental. However, in its Q&A, the Commission states that such companies 'cannot be excluded as such a priori' and that 'each situation needs to be valued on its own merits, based on substance, not on form'.<sup>127</sup>

Secondly, the entity must pool capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors. The necessity of asset pooling is used in many definitions of 'collective investment undertakings' or 'investment funds', including the one used in this book, and aims at excluding individual portfolio management.

Thirdly, ESMA has included a definition of 'day-to-day discretion or control', defined as a form of direct and ongoing power of decision over operational matters which extends further than the ordinary exercise of decision through voting at shareholder meetings. The guidelines provide that the investors have no day-to-day control over the AIF, as the AIFM must have the responsibility for the management of the AIF's assets.<sup>128</sup> This criterion refers to the 'professional management' criterion which excludes from the scope of the AIFM Directive investors self-managing a fund and investment clubs whose investors participate in the making of investment decisions.<sup>129</sup> Consequently, a private equity or real estate structure that is in fact a co-management arrangement for a particular asset where each of the investors directly co-owns the underlying asset under management, may be excluded from the scope of the directive. However, such arrangements should be fully co-owned, as ESMA states that even if one of more of the investors have day-to-day control, the fact that others do

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125. ESMA, Final report – Guidelines on key concepts of the AIFMD, 31 (under 12).

126. ESMA, Final report – Guidelines on key concepts of the AIFMD, 29.

127. Q&A on the AIFM Directive, ID 1164, Scopes and exemptions.

128. ESMA, Discussion paper – Key concepts of the Alternative Investment Fund Managers Directive and types of AIFM, 11 ('The AIFM or internally-managed AIF must have responsibility for the management of the AIF's assets. Investors have day-to-day no discretion or control over these assets').

129. Zetsche, *The Alternative Investment Fund Manager Directive*, 42.

not have this control implies that the undertaking may still be a collective investment undertaking.<sup>130</sup>

### 3.4 INTERNAL CONTROL SYSTEMS

Internal control systems consist of a set of internal rules, policies, and procedures an organization implements to ensure that, through a process of identifying, measuring, managing and monitoring the main risks, its operations are in line with the applicable laws and regulations. Rules related to internal control systems of investment funds typically aim at the monitoring and management of prudential risk by securities authorities and the protection of investors. This also follows from the impact assessment on the AIFM Directive, which states that the AIFM framework aims, among other things, the management of micro-prudential risks through ‘the imposition of strict risk management controls on market, liquidity, counterparty (credit and settlement, especially in case of short selling) and operational risks’ and the improvements in investor disclosures and effective due diligence by ‘ensuring the proper management of conflicts of interest and imposing independent controls and processes in key risk areas, in particular valuation and custody functions’.<sup>131</sup> The UCITS Directive focuses mainly on the protection of investors, as its preamble provides that it is ‘necessary, for the protection of investors, to guarantee the internal overview of every management company in particular by means of a two-person management system and by adequate internal control mechanisms’.<sup>132</sup>

In general, EU rules related to internal control systems for funds encompass a set of mandatory policies and procedures that must be implemented by the fund under EU law, which includes: (1) procedures on preventing or managing conflicts of interest, (2) risk management procedures, (3) liquidity management policies, (4) procedures for the valuation of assets, and (5) remuneration policies. The five types of internal control systems are discussed below.

#### 3.4.1 Conflicts of Interest Policies

Controlling conflict of interest situations is an important aspect of investor protection. As mentioned, an inherent conflict of interest exist between fund managers and investment funds.<sup>133</sup> With the level of management fee representing the fund manager’s revenue, the manager may have an incentive to increase investment risk, especially in case a performance-based fee is granted to the manager. In addition, there is also a risk that the manager favours accounts of funds that earn performance-based fees over those that do not or that it carries out transaction on behalf of the fund with

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130. ESMA, Final report – Guidelines on key concepts of the AIFMD, 31 (under 12(c)).

131. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 29.

132. Recital 10 of the preamble to the UCITS Directive.

133. See section 2.2.1.

affiliated parties (such as a broker-dealer or bank). To mitigate such conflicts and possible adverse consequences to investors, the EU regulator requires funds to adopt so-called conflicts of interest policies.

In this respect, the UCITS and AIFM Directive and corresponding regulations appear to be nearly the same. Both directives require the fund manager (or, in case of a self-managed UCITS, the UCITS itself),<sup>134</sup> to maintain an effective conflicts of interest policy designed to identify, prevent, manage and monitor conflicts of interests in order to circumvent them from damaging the interests of investors.<sup>135</sup> The Commission has adopted additional legislation regarding, among others, the internal control systems of UCITS and AIFs which provide insight into the types of conflicts that the manager should take into account and the organizational and administrative procedures that should be followed to manage these conflicts.<sup>136</sup>

The types of conflicts concern situations where the UCITS management company or AIFM (or a relevant person or a person directly or indirectly linked by way of control to the manager):<sup>137</sup> (1) is likely to make a financial gain at the expense of the UCITS/AIF or its investors, (2) has an interest in an outcome that is distinct from the UCITS' or AIF's interest in that outcome, (3) has an incentive to favour the interests of AIFs, UCITS, another client or group of clients over another, or one investor over another, (4) carries out the same activities for the AIF or UCITS and for another AIF, UCITS or client, or (5) receives or will receive from a person other than the UCITS or AIF an inducement in relation to collective portfolio management activities provided to the UCITS or AIF, other than the standard commission or fee for that service.<sup>138</sup>

Examples of conflict of interest situations mentioned by the EU regulator for UCITS and AIFs, include, among others: the delegation of activities (e.g., property and facility management of a real estate fund) to a member of the group to the detriment of the fund or its investors (for instance when the delegate is a poor provider), assets held by the fund have been purchased from or sold to relevant persons or persons directly or indirectly linked by control to the AIFM or UCITS management company, an AIFM manages both an AIF and a UCITS while the AIF has a long position and the UCITS a

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134. Hereafter, it will be referred to UCITS management companies which also includes UCITS self-managed funds.

135. Article 14(2)(c) of the UCITS Directive and Article 14(1) of the AIFM Directive.

136. Commission Directive 2010/43/EU of 1 Jul. 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organizational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company, OJ L 176, 42 (Directive 2010/43/EU) and the Commission Delegated Regulation on AIFMs.

137. The term 'relevant person' means a director, partner or equivalent, or manager of the UCITS management company or AIFM, an employee of the UCITS management company or AIFM, as well as any other natural person whose services are placed at the disposal and under the control of the UCITS management company or AIFM and who is involved in the provision by the UCITS management company or AIFM of collective portfolio management, or a natural person who is directly involved in the provision of services to the UCITS management company or AIFM under a delegation arrangements to third parties for the purpose of the provision by the UCITS management company or AIFM of collective portfolio management. See Article 1(2) of the Commission Delegated Regulation on AIFMs.

138. Article 17(1) of Directive 2010/43/EU and Article 30 of the Commission Delegated Regulation on AIFMs.

short one in the same asset, cross trades between two AIFs or between an AIF and a UCITS on terms that put one of the parties at a disadvantage, and soft commission agreements with brokers, target AIFs/UCITS or target companies.<sup>139</sup> The fund manager is required to create a conflict of interest policy that identifies such situations and assesses the potential risks of damage to the fund's interests or its investors. For this identification, the manager should not only take into account its own activities, but also the activities carried out by a delegate, sub-delegate, external valuer and/or counterparty.<sup>140</sup>

In order to prevent damaging the investors, the fund manager should furthermore adopt procedures and measures to ensure that relevant persons engaged in different business activities that could involve conflicts of interest carry out these activities on an appropriately independent level. Such measures may include, where necessary, the adoption of appropriate 'Chinese walls' and segregation of duties. When the measures could not prevent the risk of damage to the interest of investors, the senior manager or other internal competent body of the manager must be immediately informed and provided with the task to ensure that the manager acts in the best interest of the fund and/or its investors.<sup>141</sup> Investors must be informed about such situations 'by any appropriate durable medium' and should be given reasons for any decision made in this respect.<sup>142</sup>

### 3.4.2 Risk Management Policies

Under Article 51(1) of the UCITS Directive, UCITS management companies must employ a risk management process which enables it to monitor and measure on an ongoing basis the risk of the positions and their contribution to the overall risk profile of the fund. Article 15(2) of the AIFM Directive provides for a similar rule. The risk management process of the fund manager covers three general areas: risk measurement, risk control, and risk monitoring.<sup>143</sup>

139. See on these and other examples ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/379, 16 Nov. 2011, 53–55.

140. Article 18(2)(a) of Directive 2010/43/EU (referring to 'collective portfolio management activities carried out by or on behalf of the management company', which include, among others, investment management and valuation and pricing, but however not the activities of a counterparty) and Article 31(2)(a) of the Commission Delegated Regulation on AIFMs.

141. Articles 19(2) and 20(2) of Directive 2010/43/EU and Articles 32(2) and 34 of the Commission Delegated Regulation on AIFMs. In the case of UCITS, the obligation is to act in the best interest of both the UCITS and its investors, whereas in the case of AIFs, the manager must act in the best interest of the AIF *or* its investors. As a consequence, the AIFM may decide that a conflicting situation is allowed because it is in the interest of the AIF, even if investor interests are damaged. This could for example occur when an AIFM extends the statutory life of an AIF in order to gain ongoing charges.

142. Article 20(3) of Directive 2010/43/EU and Article 36(1) of the Commission Delegated Regulation on AIFMs. If the UCITS management company or AIFM chooses to publish conflict of interest situations via its website, certain additional criteria apply. See for UCITS, Article 38 of Commission Regulation No. 583/2010 (if the information is disclosed in the KII or prospectus) and for AIFMs, Article 36(2) of the Commission Delegated Regulation on AIFMs.

143. Szylar, *Risk Management under UCITS III / IV: New Challenges for the Fund Industry*, 108–109.

**[A] Risk Measurement**

Risk measurement refers to the identification and calculation of all risk exposures of the fund. The procedure should contain measures that enable the manager to assess the exposure for each fund it manages to market, liquidity, counterparty risk, and all other risks that may be material to investors, such as operational risk. It should include the techniques, and tools that are deemed suitable to measure the risk factors attached to an investment strategy and the management styles adopted for the fund that are relevant to investors.<sup>144</sup> Such techniques should include both quantitative measures, as regards quantifiable risks, and qualitative methods.<sup>145</sup> With respect to UCITS, it is determined that Member States may require UCITS to apply the commitment approach, the Value at Risk (VaR) relative or absolute method, or other advanced risk measurement methodologies that are appropriate to measure risk 'taking into account the investment strategy pursued by the UCITS and the types and complexities of the financial derivative instruments used, and the proportion of the UCITS portfolio which comprises financial derivative instruments'.<sup>146</sup> Each of these methods may produce differing results.<sup>147</sup> The CESR has adopted guidelines with respect to the use of the commitment or VaR method for UCITS and stated that 'a UCITS may consider appropriate for the calculation of global exposure only those methodologies on which CESR has published level 3 Guidelines'.<sup>148</sup>

The CESR guidelines include rules on the way to convert financial derivatives into equivalent positions, the calculation of exposure when using efficient portfolio management techniques, and the methodology for the computation of the global exposure when using relative and absolute VaR. When a UCITS uses the VaR method, it should disclose the expected level of leverage employed and the possibility of higher leverage levels during the relevant period.<sup>149</sup> Furthermore, when using the relative VaR approach, information on the reference portfolio should be disclosed in the prospectus. In addition, the UCITS should disclose in its annual report the risk methodology used and, in case the VaR method is used, the VaR measure, the level of leverage employed during the relevant period, and, when using the relative VaR approach, information on the reference portfolio.<sup>150</sup> Furthermore, ESMA adopted guidelines for certain structured UCITS which allows them to use an alternative application of the commitment

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144. Article 38(1) of Directive 2010/43/EU and Article 40(2) of the Commission Delegated Regulation on AIFMs.

145. CESR, Risk management principles for UCITS, CESR/09-178, February 2009, 16 and ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 67.

146. Article 41(3) of Directive 2010/43/EU. The VaR method measures the maximum loss of a portfolio value that will occur over some period at some specific confidence level due to normal market factors. See P. Penza & V.K. Bansal, *Measuring Market Risk with Value at Risk* 62 (John Wiley & Sons 2001). See for the commitment method, n. 211 and accompanying text, *infra*.

147. R.W. Helm, D.P. Dick & G.S. Schneberger, *Investments in Derivatives by U.S. and European Mutual Funds*, 44 Rev. Sec. & Commodities Reg. 135 (2011).

148. CESR, CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788, 28 Jul. 2010, 5.

149. *Ibid.*, 35.

150. *Ibid.*, 35–36.

approach.<sup>151</sup> It follows from the CESR and ESMA guidelines that non-structured UCITS may only use the VaR or commitment method and that structured UCITS may use these methods or an alternative application of the commitment method as long as they comply with the applicable set of guidelines.

AIFMs are not required to use a specific method, but are only held to adopt measures that are ‘proportionate to the nature, scale and complexity of the business of the AIFM and of each AIF it manages’.<sup>152</sup> The rationale behind this is the fact that the AIFM sector is considered to be more heterogeneous than the UCITS sector, which would make it more appropriate to impose adequate controls that ensure that there are sufficient controls and that the risk profile disclosed to investors is aligned with the actual risk profile of the AIF (i.e., risk control).<sup>153</sup> However, although the risk profile has to be measured based on reliable data,<sup>154</sup> the underlying calculation method used to measure an AIF’s risk exposure may be inadequate. For example, it is generally argued that the ‘snapshot’ style of the VaR method does not take into account the dynamics of active strategies.<sup>155</sup> Furthermore, the standard deviation or variance method concentrates on past returns and the downside and upside risk of a particular security, but does not consider risks when distributions are not symmetrical which is the case for mostly dynamic strategies and options with asymmetric payoff profiles.<sup>156</sup> In general, there appears to be no single method that is appropriate for the AIFM industry as a whole. It therefore depends on the particular AIF and the strategies used by the AIFM which method or combinations of methods are most appropriate. In any case, the AIFM Directive raises a risk for investor protection on this issue. In absence of a uniform standard used at EU level, it is up to the individual Member States and codes of conduct to make sure that adequate methods are being used.<sup>157</sup> In addition, appropriate stress testing should enable the AIFM to review the methods use and address its key risks (see below).

151. ESMA, Final Report – Guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS, ESMA/2011/112, 14 Apr. 2011.

152. Article 45(2) of the Commission Delegated Regulation on AIFMs.

153. ESMA, Final report – ESMA’s technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 61 (‘ESMA has not provided advice on the specific construction of the portfolio stress tests that AIFMs may perform. ESMA considers it is more appropriate to focus on and to enhance the governance structures envisioned under the UCITS Directive to ensure that there are robust controls that ensure the risk profile disclosed to investors is aligned with the actual risk profile of the AIF’).

154. Article 43(1)(a) of the Commission Delegated Regulation on AIFMs. However, when data is aggregated, it must be noted that some assumptions regarding this data (e.g., valuation and external analysis), may result in misrepresentation that the AIFM must be aware of. Zetsche, *The Alternative Investment Fund Manager Directive*, 316.

155. W.V. Bud Haslett, *Risk Management: Foundations for a Changing Financial World 200* (John Wiley & Sons 2010).

156. *Ibid.*, 198.

157. In current codes of conduct adopted by the AIFM industry, such as the European Private Equity and Venture Capital Association (EVCA), *Handbook on the Professional Standards for Private Equity and Venture Capital* (July 2011), however, do not provide for such rules. The EVCA Handbook can be found at EVCA’s website: <http://www.evca.eu/>.

**[B] Risk Control**

Risk control refers to the control of the risk measures implemented by the fund. It requires the fund manager to review the risk management system on an ongoing basis, including the risk measurement methods used to determine the risk profile of each fund it manages. To make sure that the risk measurement framework remain accurate and viable, AIFMs should conduct periodic ‘back- and stress testing’ to verify that the model-based forecasts and estimates correspond to the actual values of the relevant risk measures (‘back testing’) and to address risks arising from potential changes in market conditions (‘stress testing’).<sup>158</sup>

UCITS are only required to perform these tests in case appropriate, i.e., for UCITS with a complex risk profile.<sup>159</sup> When such testing would result in a revision of the methods used, this must be notified to their home Member State of the AIFM/UCITS.<sup>160</sup> In addition, they must establish and implement a quantitative or qualitative risk limits, approved by the fund’s board, taking into account all relevant risks. This includes establishing procedures that, in the event of a breach of those limits, result in timely remedial actions in the best interest of investors.<sup>161</sup> Furthermore, another control mechanism can be found in the fact that the risk management policy as a whole should be approved by the fund board.<sup>162</sup> Finally, UCITS management companies and AIFMs are required to establish a hierarchically and functionally independent ‘permanent risk management function’. The primary role of the risk management function is the implementation of the fund’s risk management policies, ensuring compliance with risk limits, advising on the risk profile of funds and, with respect to UCITS, reviewing the valuation of assets.<sup>163</sup> Despite complaints by the AIFM industry, this requirement also applies to AIFMs, although it is subject to a principle of proportionality. Member States may thus choose to not apply this requirement if it would be disproportionate (e.g., for a small AIFM), provided that the relevant AIFM can demonstrate that there are adequate safeguards against conflicts of interest so that the risk management is ‘consistently effective’.<sup>164</sup>

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158. Article 45(3)(b) and (c) of the Commission Delegated Regulation on AIFMs. Back-testing involves comparing observed with expected outcomes. Ideally it should be based on a comparison of the portfolio’s end-of-day value and, assuming unchanged positions, its value at the end of the following day. Stress-testing is a method to determine the effect on the value of a portfolio in stress situations. See, e.g., C. Muller & A. Ruttians, *A Practical Guide to UCITS Funds and Their Risk Management* 125 & 128 (Edipro 2013).

159. Article 40(2)(b) and (c) of Directive 2010/43/EU.

160. Articles 39(2) of Directive 2010/43/EU and 41(4) of the Commission Delegated Regulation on AIFMs.

161. Articles 40(2)(d) of Directive 2010/43/EU and (f) and 44 and 45 (1)(b) of the Commission Delegated Regulation on AIFMs.

162. This is because the policy is part of the instruments of corporation or trust/LP agreement of the fund.

163. Articles 12 of Directive 2010/43/EU and 39 of the Commission Delegated Regulation on AIFMs.

164. Article 40(4)(d) of the Commission Delegated Regulation on AIFMs.

**[C] Risk Monitoring**

Risk monitoring includes the supervision and oversight of the risk management function. More specifically, it places a requirement on the manager to report to the risk management function on the effectiveness of the risk management process and remedial actions taken against defences in the process. The board of directors of the UCITS management company or AIFM should provide the risk management function with all the information needed to perform its reviewing duties.<sup>165</sup> Furthermore, the risk management policies employed by the fund manager and any material changes thereof must be disclosed to the home Member State and investors.<sup>166</sup>

**3.4.3 Liquidity Management Policies**

Although liquidity management is part of an entity's overall risk management system, it is generally mentioned as a separate category due to its importance for the fund industry, especially for open-end funds.<sup>167</sup> Liquidity management aims to monitor liquidity risk and to ensure an adequate corresponding balance between cash inflows and cash outflows. In essence, it ensures that an entity is able to pay off its short term debt by selling its liquid assets. Directive 2010/43/EU requires that UCITS management companies employ an appropriate liquidity risk management process in order to ensure that each UCITS they manage is able to comply at any time with the redemption rules set out in Article 84(1) of the UCITS Directive.<sup>168</sup> CESR guidelines regarding risk management principles for UCITS also emphasize the importance of managing liquidity risk by UCITS, as they mention it as one of the key risks that should be covered by the ongoing risk management operations of the fund.<sup>169</sup>

Directive 2010/43/EU provides for two requirements regarding the liquidity management policy of UCITS: (1) UCITS management companies should, where appropriate, conduct stress tests to assess the liquidity risk of the UCITS under exceptional circumstances, and (2) the liquidity profile of the UCITS should be appropriate to the redemption policy of the fund.<sup>170</sup> In 2013, the IOSCO published a report containing principles on liquidity risk management for investment funds which

165. Articles 12(4) of Directive 2010/43/EU and 39(2) of the Commission Delegated Regulation on AIFMs.

166. Articles 39(3) of Directive 2010/43/EU, 70(4) of the UCITS Directive and 41(4) and 108(5), 110(2)(c) of the Commission Delegated Regulation on AIFMs. For UCITS, the risk management policies are subject to review by their home Member States on an ongoing basis and when granting authorization, whereas AIFMs must only report periodically on the main features of their risk management policies to investors. UCITS must provide, on request, information about their risk management policy to investors and AIFMs are required to include this information in the periodic disclosure documents to investors.

167. Open-end funds are required to meet investors' redemptions requests, which may cause for liquidity problems.

168. Article 40(3) of Directive 2010/43/EU.

169. CESR, Risk management principles for UCITS, 16.

170. Article 40(3) and (4) of Directive 2010/43/EU.

provides some further guidance on this issue.<sup>171</sup> The principles provide, among other things, that a fund manager should make best efforts to manage future cash flows (e.g., negotiating a pre-notice period with brokers before changes in margin call formulas become effective) and should consider risk factors to assess the liquidity of the underlying securities of the fund and ensure compliance with defined liquidity limits and redemption policies.<sup>172</sup> The principles also mention the importance of stress tests (in both normal and exceptional situations, such as atypical redemptions) and the disclosure of liquidity risk in the fund's annual report and in other manners to investors.<sup>173</sup> A stress test may include, for example, an analysis of the number of days that it takes to sell assets and meet liabilities in stressed situations, taking into account expected behaviour of other market participants and liquidity management actions taken by the fund manager.<sup>174</sup>

With respect to AIFMs, Article 16(1) of the AIFM Directive requires that AIFMs, for each unleveraged closed-end AIF they manage, should employ an appropriate liquidity management system, adopt procedures to monitor the liquidity risk of the AIF and ensure that the liquidity profile of the AIF complies with its underlying obligations. Furthermore, Article 16(2) of the AIFM Directive provides that for each AIF an AIFM manages, whether unleveraged closed-end in nature or not, it should be ensured that the investment strategy, liquidity profile and redemption policy are consistent with each other. The Commission Delegated Regulation on AIFMs sets out further rules on liquidity management for AIFMs which are very much alike to the IOSCO principles.<sup>175</sup> Unleveraged closed-end AIFs are required to implement 'liquidity management tools' which can be used to manage liquidity risk.<sup>176</sup> The liquidity management process of AIFMs, including the liquidity management tools and any material changes in the process, should be disclosed to investors in the pre-contractual disclosure document or promptly in the case of a material change and periodically in the case of new policies.<sup>177</sup>

### 3.4.4 Valuation Policies

In light of the risk of inaccurate valuation of the fund's shares, UCITS management companies should adopt appropriate procedures for the independent valuation of the assets of the funds they manage.<sup>178</sup> In this context, Directive 2010/43/EU states that

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171. IOSCO, *Final Report – Principles of Liquidity Risk Management for Collective Investment Schemes*, FR 03/13 (March 2013).

172. *Ibid.*, 9–10.

173. *Ibid.*, 10.

174. *Ibid.*

175. See Article 47(1)(a)-(c) (regarding the management of cash flows), 47(1)(d) (regarding the assessment of risk factors), 48 (regarding stress tests) of the Commission Delegated Regulation on AIFMs.

176. These tools may include, among others, partial redemptions, temporary borrowings, notice periods, and suspensions. Article 47(1)(e) of the Commission Delegated Regulation on AIFMs and Zetsche, *The Alternative Investment Fund Manager Directive*, 328.

177. Articles 23(1)(h) and (4)(b) of the AIFM Directive and 47(1)(e) and 108(3) of the Commission Delegated Regulation on AIFMs.

178. Article 8(3), 22(3) of Directive 2010/43/EU.

Member States should ensure that UCITS management companies ‘establish appropriate procedures to ensure the proper and accurate valuation of the assets and liabilities of the UCITS’. However, what constitutes an ‘accurate valuation’ is not further specified. This is left to the Member States. This also follows from Article 85 of the UCITS Directive, which stipulates that the valuation of assets of UCITS must be laid down in national law, fund rules or in the instruments of incorporation of the UCITS.

In general, the latest official market closing prices are used to value publicly-traded securities or at a price considered to be an appropriate, fair market price. According to CESR, ‘pricing in the instrument should ideally be readily available, regular and independent of the issuer. The UCITS’s overall valuation must be fairly and accurately reflect the value of its underlying assets’.<sup>179</sup> In case of securities traded on a regulated market, the price can be determined by the closing market price. For other financial assets, CESR provides for a number of factors which may be considered by the UCITS in determining whether or not an asset can be assumed to be ‘liquid’, which may also be helpful in this respect, including the volume and turnover in the instrument, the bid and offer prices over a period of time, the quality of secondary market activity, and the number of intermediaries and market makers dealing in the instrument concerned.<sup>180</sup> With respect to OTC derivatives that are not listed or traded on regulated markets, there are prescribed rules.<sup>181</sup>

For AIFMs, a number of rules have been imposed relating to the valuation of the assets of the AIFs they manage. However, similar to the regulations applying to UCITS, the rules do not get into the methods of valuation used, although some disclosure and control procedures apply on them,<sup>182</sup> but merely provide rules regarding the valuation policy that must be implemented and the frequency of valuation. Article 19(3) of the AIFM Directive provides that assets must be valued and the NAV per share calculated on the occasion of each issue or subscription or redemption or cancellation of shares or – in the case of a closed-end AIF – in the event of an increase or decrease of the capital of the relevant AIF. However, for closed-AIFs, calculation should occur at least once a year.

AIFMs must ensure that there is a consistent application of valuation policies across all of the AIFs it manages, taking into account the investment strategies and types of assets held by the AIF, and, if applicable, whether the AIFs use different

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179. CESR’s Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS Consultation Paper, 10.

180. CESR’s guidelines concerning eligible assets for investment by UCITS, 6.

181. Article 44 of Directive 2010/43/EU. So must the UCITS management company put in place valuation procedures for derivatives that are appropriate to their level of complexity, and details of the valuation process must be disclosed to investors. Article 44(1) of Directive 2010/43/EU. These rules also apply to other, less liquid or complex transferable securities or money market instruments. See recital 28 to Directive 2010/45/EU.

182. Article 68 of the Commission Delegated Regulation on AIFMs (providing, among other things, that for the choice of the model, the underlying data, the assumptions used in the model and the rationale for using them, and the limitations of the model-based valuation shall be appropriately documented, should be explained in the valuation process and that the model is validated by a person with sufficient expertise who has not been involved in the process of building that model).

external valuers.<sup>183</sup> AIFMs that perform in-house valuations must, according to the Commission Delegated Regulation on AIFMs, take into account a number of factors, including the competence and independence of the personnel conducting the valuation, the specific strategies and assets of the AIF, the control over the valuation method, and the appropriate time for closing the books for valuation purposes.<sup>184</sup> The valuation policy must be reviewed by the AIFM periodically, and at least once a year or before an AIF engages with a new investment strategy or type of asset.<sup>185</sup> The policy must be disclosed to investors prior to the investment.<sup>186</sup>

### 3.4.5 Remuneration Policies

In light of the financial crisis of 2007, the issue of remuneration in the financial sectors, especially performance-based fees, drew the attention of both EU and US securities regulators. It was generally perceived that the financial crisis ‘revealed that the remuneration and incentive schemes commonly applied within financial institutions were themselves exacerbating the impact and scale of the crisis’ and that these schemes created ‘incentives for taking excessive risk’, which increases systemic risk.<sup>187</sup> At the EU level, this has resulted in the adoption of a set of rules related to the remuneration of fund managers in UCITS V (which amended the original UCITS Directive)<sup>188</sup> and the AIFM Directive.

For the most part, UCITS V aligns with the AIFM Directive on remuneration requirements.<sup>189</sup> Both directives provide restrictions on the use of variable remuneration (although still allowed), rules on remuneration policies for UCITS and AIFs, and disclosure rules relating to the remuneration paid by the management company and the carried interest paid by the UCITS or AIF. With respect to the remuneration restrictions, fixed and variable components (including carried interest) must be appropriately balanced, and the fixed component must represent a sufficiently high portion. Furthermore, for the variable components of remuneration, additional requirements apply, including the requirement that guaranteed variable remuneration may only occur when hiring new staff, and only for the first year. See for these and other remuneration rules, section 2.5.

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183. Article 69 of the Commission Delegated Regulation on AIFMs.

184. Article 67(2) of the Commission Delegated Regulation on AIFMs.

185. Article 70(1) of the Commission Delegated Regulation on AIFMs.

186. Article 23(1)(g) of the AIFM Directive.

187. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed UCITS V Directive, 7.

188. Directive 2014/91/EU of the European Parliament and of the Council of 23 Jul. 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, OJ L 257, 186 (UCITS V).

189. The Commission has pointed out three reasons for this: (1) the growing use of complex strategies among UCITS and ‘exotic’ products coupled with an increase in performance fees, (2) creating a level playing field with the banking and AIFM sector, (3) providing harmonized rules for group-wide asset managers. European Commission, DG Internal Market and Services Working Document, Consultation Paper on the UCITS Depositary Function and of the UCITS Managers’ Remuneration, MARKT/G4 D (2010) 950800, 14 Dec. 2010, 26–27.

With respect to remuneration disclosure, UCITS are required to ‘appropriately balance’ the remuneration paid and disclose it to investors in their annual report.<sup>190</sup> To limit circumvention of the remuneration rules by outsourcing the asset management to third countries, ESMA has launched a public consultation on its draft guidelines on the scope of staff that shall be covered by these remuneration principles.<sup>191</sup> The proposed guidelines provide guidance on issues such as proportionality, governance of remuneration, requirements on risk alignment and disclosure and are, in line with the general intent of the Commission to provide for convergence relating to this issue between UCITS and AIFMs, to a large extent, similar to those applying to AIFM’s. In the ESMA guidelines applying to AIFMs and the proposed guidelines for UCITS, ESMA determines that AIFMs and UCITS management companies ‘should consider the additional disclosure on remuneration required under paragraph (8) of the Recommendation’, which information can be disclosed ‘through an independent remuneration policy statement, a periodic disclosure in the annual report or any other form’ as long as the disclosure ‘is clear and easily understandable and accessible’.<sup>192</sup> This disclosure obligation comes in addition to the KII cost disclosure requirements for UCITS and the requirement to disclose all fees, charges and expenses which are directly or indirectly borne to investor to potential investors under Article 23(1)(i) of the AIFM Directive and the remuneration disclosure in annual reports under Articles 69(3) of the UCITS Directive and 22(2)(e) and (f) of the AIFM Directive.

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190. See section 2.5.4 and Article 69(3) of the UCITS Directive.

191. ESMA – Consultation Paper, Guidelines on sound remuneration policies under the UCITS Directive and AIFMD, 2015/ESMA/1172, 25 Jul. 2015. The Consultation Paper also proposes a revision of the AIFM Remuneration Guidelines by clarifying that in a group context, non-AIFM sectoral prudential supervisors of group entities may deem certain staff of an AIFM in that group to be identified staff for the purpose of their sectoral remuneration rules. The different use of criteria used to identify staff subject to the rules has also been highlighted by the Committee of European Banking Supervisors (CEBS) with respect to banking remunerations. See CEBS, *Report on National Implementation of CEBS High-Level Principles for Remuneration Policies* 4 (June 2010) (‘The scope of the [High-level Principles for Remuneration Policies], within a given institution, raises more interpretation problems, especially as to how remuneration of certain categories of staff (senior management, risk takers and control functions) should be subject to specific measures’). The CEBS report can be found at: <https://www.eba.europa.eu/>.

192. See ESMA – Consultation Paper, Guidelines on sound remuneration policies under the UCITS Directive and AIFMD, 90 (under 163) and ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 74 (under 160). This information includes, among other things, information concerning the decision-making process used for determining the remuneration policy, information on linkage between pay and performance, information on the performance criteria, and the main parameters and rationale for any annual bonus scheme and any other non-cash benefits. However, ESMA states that small or non-complex AIFMs/AIFs or UCITS management companies/UCITS will only be expected to provide some qualitative information and very basic quantitative information where appropriate under consideration of the proportionality principle. See ESMA – Consultation Paper, Guidelines on sound remuneration policies under the UCITS Directive and AIFMD, 91 (under 165) and ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 75 (under 162).

### **[A] UCITS Policies**

With respect to the remuneration policies for UCITS, UCITS V requires UCITS management companies to establish, oversee and review remuneration policies that promote sound risk management and to disclose aggregate information on remuneration in the UCITS annual report.<sup>193</sup> The remuneration policies rules are based on the same principle as the requirements on other internal control systems: they do not specify the remuneration policies for all UCITS management companies. The Commission explains this point of view in its impact assessment on UCITS V, stating that this would be ‘very intrusive and disproportionate as it would not take into account differences in the business models of UCITS management companies, their sizes and managerial practices’.<sup>194</sup>

The scope of the application of the remuneration policies is set very broad as they should cover all staff that can impact the UCITS’ risk profile, including ‘senior management, risk takers, control functions and any employee receiving total remuneration that falls within the remuneration bracket of senior management and risk takers and whose professional activities have a material impact on the risk profiles of the management companies or of UCITS they manage’.<sup>195</sup> This may also include delegates that impact on the risk profile of the UCITS, e.g., a delegated (portfolio) manager. The remuneration policies should be in line with the business strategy, objectives, values and interests of the management company, the UCITS it manages and its investors.<sup>196</sup> At least once a year, compliance with the remuneration policies must be reviewed by a central and independent internal auditor.<sup>197</sup> Larger UCITS management companies are required to establish a remuneration committee, which is responsible for the preparation of decisions regarding remuneration and to directly oversee remuneration of the senior officers in risk management.<sup>198</sup>

### **[B] AIF Policies**

AIFMs, as mentioned, must establish remuneration policies for staff members whose activities impact the risk profile of the AIFM or the AIF it manages. The policies must be consistent with and promote sound risk management and must not encourage risk-taking which is beyond the AIF’s risk profile.<sup>199</sup> As with UCITS, the policies apply to ‘identified staff’, which includes non-executive (as well as executive) members of the AIFM’s governing body. In its guidelines on remuneration policies for AIFMs, ESMA provided a definition of this term that is equal to the list of identified staff to which the UCITS remuneration rules apply. However, ESMA explicitly adds to the

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193. Article 14(a)(1) and 69(3) of the UCITS Directive.

194. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed UCITS V Directive, 42.

195. Article 14(a)(3) of the UCITS Directive.

196. Article 14(b)(1)(b) of the UCITS Directive.

197. Article 14(b)(1)(d) of the UCITS Directive.

198. Article 14(b)(1)(f) and (3) of the UCITS Directive.

199. Article 13(1) of the AIFM Directive.

definition staff of the AIFM or AIF to which portfolio or risk management have been delegated and whose professional activities have a material impact on the risk profiles.<sup>200</sup> Furthermore, ESMA clarifies the term ‘risk takers’ as including persons capable of entering into contracts/positions and taking decisions that materially affect the risk positions of the AIFM or of an AIF it manages, such as sales persons, individual traders and specific trading desks.<sup>201</sup>

The examples given by ESMA are not exhaustive. External service providers which do not have the power to take any decisions are not covered. For example, advisers that only provide advisory services per definition do not have a material impact on the AIFM’s risk profile or on an AIF it manages and should therefore not be qualified as identified staff. Staff responsible for heading the portfolio management, administration, marketing, and human resources is however included in ESMA’s definition of identified staff.<sup>202</sup>

The guidelines also provide that, in exceptional cases, based on size, internal organization, scope and complexity of activities, some of the remuneration provisions can be disapplied entirely, including establishing a remuneration committee, delivering at least 50% of variable remuneration in the form of units or shares in the AIF, and the deferral, retention and performance adjustment mechanisms (i.e., malus or clawback).<sup>203</sup> ESMA refers in this respect to the Commission Recommendation on remuneration policies in the financial sector, which mentions that when taking measures to implement remuneration principles, Member States should take account of the size nature and scope of financial undertakings’ activities.<sup>204</sup> An AIFM should make its own assessment for each remuneration requirement to determine whether proportionality allows it to not apply the requirement, subject to review by the competent authorities of its Member State.<sup>205</sup> This opens up possibilities for, for example, small-AIFMs – depending on whether or not the AIFs they manage are systemically important or use complex investment strategies – to discard some of the stringent remuneration rules.<sup>206</sup> This may pose a risk of circumvention of the rules. As the Commission Recommendation concerns the financial sector of a whole, similar guidelines are likely to be adopted for UCITS, although the focus on a high level of

200. ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 47.

201. *Ibid.*, 51.

202. *Ibid.*, 52 (under 20).

203. *Ibid.*, 52–53 (under 26).

204. *Ibid.*, 52 (under 23). See for the Commission Recommendation: Commission Recommendation of 30 Apr. 2009 on remuneration policies in the financial sector, OJ L 120, 22.

205. ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 53 (under 28).

206. ESMA identified a number of criteria that are relevant to justify a proportionate implementation of the remuneration principles, among which, the value of the AIFM capital and the assets under management, the potentially systemically importance (e.g., in terms of total assets under management) of the AIFs or complex investment management activities, the complexity of the internal governance structure of the AIFM, and, with respect to different categories of staff, the size of the obligations into which a risk taker may enter on behalf of the AIFM and the structure of the remuneration. *Ibid.*, 53–54.

investor protection in the UCITS framework may also result in a more limited application of the proportionality principle.<sup>207</sup>

Another interesting aspect of the ESMA's guidelines, which deviates from the UCITS remuneration framework, is the introduction of a so-called supervisory function, which includes non-executive members. Where appropriate considering the size of the AIFM, its internal organization and the nature, scope and complexity of its activities, the management body should not determine its own remuneration, but the supervisory function, which should also oversee the remuneration of the management body.<sup>208</sup> Rationale for this requirement is to avoid apparent conflicts of interests on the part of executive staff members when determining their own remuneration.<sup>209</sup>

### 3.5 LEVERAGE RESTRICTIONS

Leverage has been defined in this book (see section 2.6.6[C]) as including both the borrowing of money and the use of derivatives by fund managers. While highly leveraged funds might create systemic risk, they also form a risk to investors as it increases the risk level of their investment (as well as their potential return). The question can therefore be raised whether funds that use leverage are suitable to retail investors. With respect to the retail-orientated UCITS, the UCITS Directive requires that UCITS cannot have a global exposure greater than its NAV. Thus, there is a hard limit to a UCITS' leverage of 100% of the NAV. In addition, the risk exposure of a UCITS may not be increased by more than 10% by means of temporarily borrowing. Consequently, the overall risk exposure of a UCITS may not exceed 210% of the NAV under any circumstances. See with respect to the risk exposure of UCITS also section 3.2.2.

Furthermore, the use of derivatives by UCITS is limited by the UCITS Directive. As discussed in section 3.2.1, UCITS may also invest in derivatives in case the underlying instrument of the derivative consists of eligible instruments covered by the directive, financial indices, interest rates, foreign exchange rates or currencies. OTC derivatives may be invested in case the counterparties to the transactions are subject to prudential supervision and valuation of the derivative is reliable and verifiable and can be sold at any time at their fair value. Short-selling is not allowed under the directive. An UCITS must provide specific disclosures in the prospectus in relation to the use of

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207. For example, only for non-complex ('traditional') UCITS. At any case, Article 14(a)(4) of the UCITS Directive provides that guidelines issued by ESMA shall take into account 'the principles on sound remuneration policies set out in Commission Recommendation 2009/384/EC, the size of the management company and the size of UCITS they manage, their internal organisation and the nature, the scope and the complexity of their activities'.

208. However, for AIFMs which are required to have a remuneration committee, the remuneration of the senior staff responsible for heading the control functions should not be solely left to the supervisory function, but should, as is also the case with UCITS, be directly overseen by the remuneration committee. *Ibid.*, 61 (under 73).

209. See ESMA, Consultation paper – Guidelines on sound remuneration policies under the AIFMD, ESMA/2012/406, 28 Jun. 2012, 24 (under 64) (referring to the conflicts of interest policies that AIFMs should adopt, which includes 'where necessary, the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities' (quotation marks omitted)).

derivatives, to clarify the outset of the purpose behind the use of the derivatives and to set out the extent to which the UCITS becomes leveraged as a result.<sup>210</sup>

AIFMs are not subject to restrictions regarding the amount of leverage they may employ, but their leverage exposure of an AIFM is relevant for determining whether or not the AIFM falls under the *de minimis* exemption provided in the directive (see section 3.3.2[B]). In addition, AIFMs are subject to a number of ongoing disclosure requirements related to their leverage exposure (see section 3.7.4).

Leveraged AIFMs must calculate leverage as a ratio of exposure to the NAV, using the gross and the commitment method. The gross method is the sum of the absolute value of all positions plus the market value of the equivalent underlying position for derivatives. The commitment method is similar to the gross method but allows for, under certain conditions, netting and hedging arrangements that aim at reducing the exposure to be excluded from the calculation.<sup>211</sup> Netting arrangements include derivatives or securities positions that refer to the same underlying asset, irrespective, in the case of derivatives, they have different maturity dates, that aim at eliminating risks linked to the positions. Hedging arrangements include derivatives or securities positions that do not need to refer to the same underlying asset that aim at offsetting risks linked to the positions. This method is based on the UCITS method.<sup>212</sup> The combination of both methods aims to provide investors (in the case of registered AIFMs) and competent authorities (in the case of registered and exempted AIFMs) with sufficient information on the leverage employed by the AIF: the gross method gives insight into the overall exposure of the AIFM and the commitment method provides insight into the hedging and netting techniques of the AIFM. In 2015, the Commission will review both methods in order to decide whether they are sufficient for all types of AIF.

### 3.6 INVESTOR MEETINGS

As with regular companies, the board of an investment fund may be required to hold an annual meeting of investors in accordance with the applicable national law. In addition, at the EU level, the Shareholder Rights Directive establishes requirements in relation to the exercise of certain shareholder rights attaching to voting shares in relation to annual meetings of ‘companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State’, i.e., EU-listed companies.<sup>213</sup> The directive allows

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210. Article 70(1) of the UCITS Directive.

211. Articles 6(5), 7 and 8 of the Commission Delegated Regulation on AIFMs. The motivation behind this is that while these instruments in principle increase the exposure of an AIF, effective hedging or netting arrangements leads to a decrease in the overall risk in the fund. See Commission of the European Communities, Commission Staff Working Document, Impact assessment on the Commission Delegated Regulation on AIFMs, 19 Dec. 2012, SWD(2012) 386 final, 22. Both arrangements are combinations of trades on derivatives or securities which are concluded with the sole aim of offsetting the exposure linked to other positions, thereby allowing AIFMs to reduce overall exposure of their AIFs. *Ibid.*

212. See on this method, CESR’s Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788, 28 Jul. 2010.

213. Article 1(1) of the Shareholder Rights Directive.

Member States to exclude from the scope of the directive UCITS and other public funds subject to national law and supervision that operate on the principles of risk-spreading and do not seek to take legal or management control over any of the issuers of their underlying investments.<sup>214</sup> EU-listed UCITS management companies, AIFMs and AIFs are however included in the scope of the directive.

With respect to the national laws of Member States regarding investor meetings of funds, it can be noted that investors are faced with a number of restrictions, among which restrictions relating to the right to place of items on the agenda, (super)majority vote restrictions, and the right to participate in meetings.

### 3.6.1 Right to Place Items on the Agenda

For corporate funds, although meetings are generally required or may be requested by investors under EU Member State law,<sup>215</sup> the provisions governing investor access to place items on the agenda or submit proposals included or to be included on the agenda are stringent. For example, in the Netherlands, investors in corporate funds must own at least 3% (in case of a large, public company, i.e., *Naamloze Vennootschap*, ‘NV’) or 1% (in case of a private limit liability company, i.e., *Besloten Vennootschap*, ‘BV’) of the issued share capital to submit proposals to be voted upon at an annual meeting.<sup>216</sup> With respect to a BV fund, the board can even decide not to place proposals on the agenda in case severe interests of the fund conflict with the proposal.<sup>217</sup> In the UK, investors in closed-end corporate funds must own at least 10% of the fund’s issued share capital in order to submit proposals to be voted upon at the annual meeting. Alternatively, a group of at least 100 investors, each with no less than GBP 100 invested, may also put forward a proposal.<sup>218</sup>

The Shareholder Rights Directive recognizes that in order to protect their interests, ‘[s]hareholders should, in principle, have the possibility to put items on the agenda of the general meeting and totable draft resolutions for items on the agenda’.<sup>219</sup> The directive requires Member States to not impose a threshold for the exercise of these rights of more than 5% of the company’s share capital and that all shareholders should receive the final version of the agenda in sufficient time to prepare for the discussion

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214. Article 1(3)(a) and (b) of the Shareholder Rights Directive.

215. However, some corporate funds, such as private companies and special corporate forms, are not required to hold annual meetings. This is for example the case with UK ICVCs and private companies, except for the removal of directors (and, in the case of UK private companies, auditors). See Articles 4.4.2(1) and 6.5.4(3) of the COLL and Articles 168, 336 and 510 of the UK Companies act. Next to annual meetings, funds may be required to hold special, extraordinary meetings requested by investors holding a certain stake in the fund. See, e.g., Article 303 of the UK Company Act (requiring directors to call a general meeting in case requested by 10% of the paid-up capital or, in case of a company with no share capital, 10% of the total voting rights, or 5% of the paid-up capital or voting rights in case of a private company that did not hold a meeting for twelve months) and Article 2:110(1) and 220(1) of the Dutch Civil Code, *Burgerlijk Wetboek Boek 2* (10% or more of the voting capital is needed to request a special meeting).

216. Articles 2:114a(1) and 224a(1) of the Dutch Civil Code.

217. Article 2:224a(1) of the Dutch Civil Code.

218. Article 314(2) of the UK Company Act.

219. Recital 7 of the Shareholder Rights Directive.

and voting on each item on the agenda.<sup>220</sup> However, as mentioned, the directive only applies to listed funds. Moreover, the threshold requirement in fact restricts minority retail investors to place items or proposals on the agenda as they will often have insufficient share capital to do so. EU contractual funds are generally not required to hold annual meetings at all, so it will depend on their fund instruments whether or not they will hold annual or extraordinary meetings and whether investors may place items/submit proposals on the agenda or have other rights.<sup>221</sup>

### 3.6.2 (Super)Majority Vote

With respect to decisions made at investor meetings, it can be noted that fund rules and regulations may provide for a majority or ‘supermajority’ vote which makes it difficult for investors to propose or vote for any change in control or other fundamental changes as regards the fund. In addition, in some cases, a quorum of presence is required. This may also be required by mandatory national law. For example, in the UK, the charter of the fund can only be changed by a 75% majority vote.<sup>222</sup> Under Dutch law, a simple majority would suffice, but 100% of the outstanding shares must be represented at the meeting in order to constitute a charter change.<sup>223</sup> In case of proposals to remove directors, EU corporate laws impose fewer restrictions. In most fund jurisdictions, directors can be removed at any time (with no cause) by the investors by simple majority. This is for instance the case in the UK and the Netherlands.<sup>224</sup> However, in Germany, corporate fund board directors can only be removed by the supervisory board for an important reason (ein wichtiger Grund) though this can include a majority vote of no-confidence by the investors.<sup>225</sup>

### 3.6.3 Right to Participate in Meetings

There are a number of restrictions relating to investors’ ability to participate in investor meetings. Firstly, meeting attendance is often hindered by the late notice periods or late

220. *Ibid* and Article 6(2) of the Shareholder Rights Directive.

221. For example, UK and Dutch law does not require UK AUTs and Dutch CVs to hold annual meetings, although they are also not prohibited to do so. This also follows indirectly from the UCITS Directive, which requires that, in case of mergers between UCITS (whether established under corporate or contractual law), Member States must ensure that prior approval of the investors does not ‘require more than 75% of the votes actually cast by unit-holders present or represented at the general meeting of unit-holders’. See Article 44 of the UCITS Directive.

222. Articles 21(1) and 283(1) of the UK Companies Act.

223. Article 2:121(1) and 2:231(1) of the Dutch Civil Code.

224. Articles 168(1) of the UK Companies Act and 2:120(1), 132(1), 142(1), 144(1), 230(1), 242(1) and 244(1) of the Dutch Civil Code. Dutch companies can however deviate from this requirement by corporate charter or by including oligarchic clauses in their articles of association that further restrict the possibility for shareholders to remove directors. Many companies appear to be using this possibility. See for possible charter articles and clauses that can be adopted, B.F. Assink & D.A.M.H.W. Strik, *Ondernemingsbestuur en risicobeheersing op de drempel van een nieuw decennium: een ondernemingsrechtelijke analyse* 117-119 (Kluwer 2009).

225. Article 84(3) of the German Stock Corporation Act.

availability and inconsistent or incomplete information regarding the agenda items up for voting.<sup>226</sup> Under the Shareholder Rights Directive, listed funds should issue relevant information about the meeting no later than twenty-one days before the day of the meeting.<sup>227</sup> This information document should contain, among other things, details on when and where the general meeting is to take place, and the proposed agenda for the general meeting, the rights of shareholders to place items/proposals on the agenda, and the procedure on proxy voting and form used.<sup>228</sup> However, the directive does not state the type of information the fund should provide regarding the agenda topics and that it should be presented in a way that is understandable to retail investors, as it only requires it to issue a 'draft resolution' or 'comment from the competent body' with respect to 'each item on the proposed agenda of the general meeting'.<sup>229</sup> With respect to shareholder proposals, the directive requires that such proposals/resolutions 'shall be added to the Internet site as soon as practicable after the company has received them'.<sup>230</sup> The notice period for annual meetings of EU non-public funds are determined by national law and may therefore be much shorter than twenty-one days.<sup>231</sup>

Secondly, investors may be discouraged from attending investor meetings because of the cumbersome share blocking practices, whereby investors must deposit their shares for a few days before annual/special meetings to be able to vote.<sup>232</sup> While the Shareholder Rights Directive requires Member States to abolish share blocking and to replace it by a record date, i.e., the requirement that shares be held at a certain date before the annual/special meeting, share blocking is still being practiced by some Member States.<sup>233</sup> Despite these restrictions, it should however be noted that many investors appear to be not interested in participating investor meetings. Reason for this may be partly because of the restrictions mentioned above, but also due to practical issues. The date of the meeting or having to travel across the country or across borders may be unattractive for retail investors. Furthermore, in case of the existence of a controlling shareholders or group of shareholders, the votes of (a minority) of retail investors are not likely to affect the outcome of the vote. Institutional investors may not attend meetings at all or vote against board proposals as they are more interested in

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226. P. Cziraki, L. Renneboog & P.G. Szilagy, *Shareholder Activism through Proxy Proposals: The European Perspective*, 16:5 *European Financial Management* 748 (2010).

227. Article 5(1) of the Shareholder Rights Directive.

228. Article 5(3) of the Shareholder Rights Directive.

229. Article 5(4)(d) of the Shareholder Rights Directive.

230. *Ibid.*

231. For example, an annual meeting of a UK private company must be called by notice of at least fourteen days. See Article 307(1) of the UK Company Act. Dutch BVs are required to meet a notice period of only eight days. See Article 2:225 the Dutch Civil Code. EU contractual funds may even apply shorter periods in accordance with their fund rules and regulations as no national regulations in this respect apply.

232. P. Cziraki, L. Renneboog & P.G. Szilagy, *Shareholder Activism through Proxy Proposals: The European Perspective*, 748.

233. Articles 7(1)(a), (b) and (2) of the Shareholder Rights Directive (requiring the record date to be not more than thirty days before the annual meeting) and European Commission, Internal Market Directorate General, Consultation Document – Fostering an Appropriate Regime for Shareholders' Rights, Internal Market Directorate General, MARKT/16.09.2004, 17 ('Although some Member States have taken steps to reform the law in this area, the practice of share blocking can still be found in many jurisdictions').

exercising influence at the fund's management via other means (i.e., the fund's investment committee or green lighting committee).<sup>234</sup> Alternatively, when they believe that the fund manager is not realizing maximum return on their investment, they may be more inclined to sell or redeem their shares ('vote with their feet') rather than to vote against board proposals or submit own proposals at an investor meeting.<sup>235</sup>

Thirdly, restrictions in attending a meeting may exist regarding to, among other things, the timeliness of information, admission fees to attend meetings charged by intermediaries, and the availability of information when shares are held via an intermediary.<sup>236</sup> Also, a fund may have issued no-voting shares to investors which makes it even impossible for them to vote.<sup>237</sup> With respect to these obstructions, it can be noted that the Commission has proposed changes to the Shareholders Rights Directive which would tackle most of these problems.<sup>238</sup> The proposal requires, among other things, that intermediaries transmit to shareholders the information necessary to exercise their rights without delay, facilitate the right to participate and vote in general meetings, and transmit voting confirmations of shareholders to the company in case the intermediary votes on their behalf. Where there is more than one intermediary in a chain of custody, which is the information should be transmitted between intermediaries without undue delay to prevent obstructions in the use of voting rights.<sup>239</sup> The proposals also include provisions on the disclosure of remuneration policies and approval of remunerations, shareholder approval on related party transactions, transparency of proxy advisers and the disclosure of voting and engagement policies and certain aspects of asset management arrangements of institutional investors and asset managers.<sup>240</sup>

234. See also section 2.7.4.

235. T.X. Duong, *Essays on Agency Conflicts in Mutual Funds 2* (ProQuest 2008) (stating, however, that these actions do presume that investors actively manage their investments).

236. EuroFinuse, *Barriers to Shareholders Engagement: Report on Cross-Border Voting 8–12* (2012). The report can be found at: <http://www.betterfinance.eu/>.

237. The Shareholder Rights Directive does not prohibit deviations in national law from the principle of 'one vote – one share'. However, the possibilities to issue such shares is limited by law in most Member States. See E. Wymeersch (ed.), *Further Perspectives in Financial Integration in Europe: Reports Presented at the Brussels Meeting of the International Faculty for Corporate Market Law and Securities Regulations* 186, note 15 (De Gruyter 1994).

238. European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, 9 Apr. 2014, COM(2014) 213 final ('Shareholder Rights Directive Proposal').

239. *Ibid.*, 5 ('In intermediated holding chains, especially when they involve many intermediaries, information is not passed to shareholders from companies or shareholders' votes get lost. There is also a greater likelihood of misuse of the voting rights by intermediaries. Three main causes affect the systems: the lack of investor identification, a lack of timely transmission of information and rights in the investment chain and price discriminations of cross-border holdings').

240. *Ibid.*, Articles 9a, 9b, 9c, 3i, 3f and 3g.

### 3.6.4 Electronic Voting

The above shows that EU investors that invest in funds that have their registered office in another Member State or non-EU investors may be faced with a number of practical difficulties in attending an investor meeting. This problem may however be solved if investors are able to vote electronically. In general, there are three ways through which electronic voting may occur: (1) electronic proxy voting, (2) electronic direct voting, or (2) virtual meetings.<sup>241</sup>

Proxy voting refers to the practice of appointing someone else to vote on your behalf. Article 10 of the Shareholder Rights Directive provides a right to shareholders to appoint any natural or legal entity as a proxy holder who will enjoy the same rights at the meeting as the shareholder and who votes at the meeting according to the shareholder's directions. According to Article 11 of the Shareholder Rights Directive, shareholders must be able to issue, or revoke, a proxy to the proxy holder by written electronic means (e.g., by mail). Furthermore, listed companies, including listed funds, should offer to their shareholders at least one effective method for giving notice to the company about the appointment, or the revocation, of the proxy by written electronic means.<sup>242</sup> Proxy holders wishing to solicit votes should be able to do so via a so-called proxy form which is placed on the fund's website. In case this is not possible, the fund's website should explain on the website how investors can obtain the form or it should be sent to investors at the fund's costs.<sup>243</sup> The rules on proxy voting are intended to remove administrative restrictions and other barriers placed by Member States on the effective use of proxy voting. However, with respect to proxy holders, there are some concerns regarding their voting transparency, which issue will most likely be addressed in the near future.<sup>244</sup>

Electronic direct voting, i.e., electronic voting without the use of a proxy holder, is also addressed Shareholder Right Directive, which requires that 'Member States shall permit companies to offer to their shareholders any form of participation in the general meeting by electronic means'.<sup>245</sup> The directive thus does not place a mandatory requirement on Member States to permit listed companies to accept electronic voting. Consequently, many EU Member States decided not to require listed companies to provide in their rules and regulations the right to shareholders to vote at annual/special

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241. D. Zetsche, *Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive*, 8 J. Corp. L. Stud. 323 (2008).

242. Article 11(1) of the Shareholder Rights Directive.

243. Article 5(4)(e) of the Shareholder Rights Directive.

244. See Article 3i of the Shareholder Rights Directive Proposal (requiring proxy advisors to adopt and implement adequate measures to guarantee that their voting recommendations are accurate and reliable, based on a thorough analysis of all the information that is available to them and are not affected by any existing or potential conflict of interest or business relationship and requiring them to disclose certain key information related to the preparation of their voting recommendations).

245. Article 8(1) of the Shareholder Rights Directive.

meetings by electronic means.<sup>246</sup> However, companies are free to establish such a right if they choose to do so.<sup>247</sup>

Finally, virtual meetings, i.e., meetings that are held entirely online, wherein shareholders and directors directly communicate and deliberate through the Internet, are not expressly addressed by the Shareholder Rights Directive. However, the directive does not prohibit such meetings as it states that Member States may adopt other legal rules related to ‘any form of participation by electronic means’.<sup>248</sup> While thus possible, however, in the EU, only Denmark has introduced the virtual meeting in its legislation.<sup>249</sup>

### 3.7 TRANSPARENCY AND DISCLOSURE RULES

As concluded in Chapter 2,<sup>250</sup> transparency and disclosure by (the managers of) investment funds are important tools in the context of investor protection. Through adequate disclosure, investors are able to evaluate risks and costs associated with an investment fund and to make an informed decision whether or not to invest in it. Sufficient and adequate disclosure also provides investors with the information they need to exercise investor rights, such as the right to vote at investor meetings.<sup>251</sup> Furthermore, it is generally assumed that disclosure enhances the verifiability of the fund’s performance, reducing the ‘moral hazard’ problem of the fund manager.<sup>252</sup>

246. For example, in the Netherlands, Dutch law requires that the charter of incorporation of a Dutch NV may provide for such a provision, but there is not a requirement to do so. See Article 2:117a of the Dutch Civil code.

247. Zetsche, *Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive*, 326 (stating that ‘[t]his type of voting in absentia is widely used among Member States’).

248. Article 8(2) of the Shareholder Rights Directive.

249. A. van der Krans, *The Virtual Shareholders Meeting: How to Make it Work?*, 2 J. Intl. Comm. L. & Tech. 33 (2007). Van der Krans points out a number of advantages of a virtual shareholder meeting. In general, he states that ‘[s]hareholders are better able to exercise their rights as a result of the increased length of time, the absence of travelling time and the improved distribution of information and communication among shareholders’. Furthermore, ‘widespread shareholders may profit from a virtual meeting by increasing shareholders’ participation’, which may improve corporate governance and the financial results of the company. *Ibid.*, 36.

250. See section 2.8.

251. See in a similar way with respect to public companies, R.H. Kraakman, *Disclosure and Corporate Governance: An Overview Essay in Reforming Company and Takeover Law in Europe* 98 (G. Ferrarini & et al., eds, Oxford U. press 2004). Kraakman identifies three governance functions of mandatory disclosure for public companies: (1) an enforcement function, discouraging opportunistic behaviour and self-dealing, (2) an educative function, informing shareholders and enabling them to make important governance decisions, and (3) a legislative function, requiring corporate issuers to comply with certain corporate governance practices or explain why they do not. *Ibid.*, 96.

252. P. Östberg, *Disclosure, Investment and Regulation*, 15 J. Fin. Intermediation 286 (2006) (‘[T]he disclosure level determines the verifiability of the firm’s assets and therefore reduces the insider’s moral hazard problem’). A moral hazard is where one party is responsible for the interests of another, but has an incentive to put his own interest first, such as fund manager that are driven by performance-based fees.

### ***Categories of Disclosure Requirements***

Both the UCITS and AIFM Directive provide for an extensive framework of transparency and disclosure rules requiring funds to provide information to their investors. In general, there are two categories of investor disclosure. Firstly, certain information may be disclosed to investors in a UCITS or AIF prior to their initial investment ('pre-contractual information'). Secondly, information is disclosed to investors after their investment ('ongoing information'). The pre-contractual disclosure documents that UCITS must provide to investors include the UCITS prospectus and KII. AIFMs are held to provide prospective investors with an AIF prospectus and a recent copy of the annual report under the AIFM Directive. In addition, AIFMs may be required to publish a prospectus under the Prospectus Directive if their shares are publicly offered or admitted to trading at an EU stock exchange, or publish a KID under the future PRIIP rules (if adopted), if they offer their shares to retail investors as defined in the PRIIP Proposal.<sup>253</sup> However, many AIF share offerings are private placements as a result of which they are exempt from these disclosure requirements.<sup>254</sup> Ongoing information for UCITS includes annual and half-yearly reports and, for AIFMs, annual reports, liquidity, risk, leverage, and conflicts of interest disclosures. In addition, both UCITS and AIFMs are held to inform investors about the UCITS' or AIF's NAV.

### ***Timing and Method(s) of Disclosure***

While the ongoing information is disclosed to investors on a continuous or periodic basis, pre-contractual information is normally provided before the investor has signed the subscription agreement for fund shares. However, some mandatory pre-contractual disclosure documents must be provided to investors at the initiative of the fund manager, and some documents, such as the UCITS prospectus, should only be provided beforehand at the request of the investor, although it will generally be available for investors via the fund's website.<sup>255</sup> In the latter case, investors might not request the information before investing in the fund. As a result, they will not receive important information contained in the document and read and consider it carefully before investing. Furthermore, the way in which (pre-contractual and ongoing) information is provided and whether or not investors should agree with the method of

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253. In case the AIFM must publish a prospectus under the Prospectus Directive (or in accordance with national law), only the additional investor information that is required under the AIFM Directive should be disclosed separately or as additional information in the prospectus. See Article 23(3) of the AIFM Directive. See for the information that a prospectus under the Prospectus Directive must contain Ch. 2 and Annex I to the Prospectus Directive and for the proposed PRIIP information requirements, section II of the PRIIP Proposal.

254. See, e.g., S.A. McCrary, *Hedge Fund Course* 288 (John Wiley & Sons 2004) ('In most cases, hedge funds issue shares in a limited liability corporation or partnership interests in a limited partner as a private placement') and S. Dresner & E.K. Kim (eds), *PIPEs: A Guide to Private Investments in Public Equity* 175 (John Wiley & Sons 2010) ('The private equity line is generally considered to be a PIPE [Private Investments in Public Equity] because it is a private equity placement with registered resale').

255. Article 75(1) of the UCITS Directive.

delivery differs between UCITS/AIFs and among the different information forms. So may the UCITS prospectus and KII be provided through the fund's website with investors' consent and are AIFMs allowed to provide the AIF prospectus to investors electronically without their expressed consent.<sup>256</sup>

In Tables 3.1 & 3.2, these aspects are indicated, which show the key types of information documents and other disclosures published by UCITS and AIFMs which are most relevant in the context of investor protection, the timing of delivery or publication of this information to (potential) investors, and the methods of delivery or publication.

*Table 3.1 Information and Delivery Requirements for UCITS*

	<i>UCITS Prospectus</i>	<i>KII</i>	<i>Annual Report</i>	<i>Half-Yearly Report</i>	<i>NAV Disclosure</i>
Type of information	Pre-contractual information	Pre-contractual information	Ongoing information	Ongoing information	Ongoing information
Timing of delivery or publication	Prior to the investment on request of investors and free of charge.	In good time prior to the investment and free of charge. <sup>257</sup>	Annually, no later than four months following the end of the financial year. <sup>258</sup>	Semi-annually, no later than four months following the end of the period to which it relates. <sup>259</sup>	At least twice a month, or to once a month in case it does not prejudice the interests of the investors and is permitted by the Member State. <sup>260</sup>

256. Articles 75(2) of the UCITS Directive and 38(2)(b) and (c) Commission Regulation No. 583/2010. In addition, UCITS must notify the investor electronically of the address of the website. AIFMs are free to choose the way in which they provide the information, which may be via the AIFM's or AIF's website or by sending the information directly to investors and/or intermediaries through its standard offering document, as a result of which the information may become publicly available. See Zetsche, *The Alternative Investment Fund Manager Directive*, 340.

257. Article 80(1) and (2) of the UCITS Directive.

258. Article 68(2)(a) of the UCITS Directive.

259. Article 68(2)(b) of the UCITS Directive.

260. See section 2.6.2.

	<i>UCITS Prospectus</i>	<i>KII</i>	<i>Annual Report</i>	<i>Half-Yearly Report</i>	<i>NAV Disclosure</i>
Method(s) of delivery or publication	Through the UCITS' website with investors' consent or any other durable medium. A paper copy must be delivered to the investors on request and free of charge. <sup>261</sup>	Through the UCITS' website with investors' consent or any other durable medium and to intermediaries. <sup>262</sup>	In a manner specified in the UCITS prospectus and KII. A paper copy must be delivered to the investors on request and free of charge. <sup>263</sup>	In a manner specified in the UCITS prospectus and KII. A paper copy must be delivered to the investors on request and free of charge. <sup>264</sup>	In an 'appropriate manner'. <sup>265</sup>

*Table 3.2 Information and Delivery Requirements for AIFMs*

	<i>AIF Prospectus</i> <sup>266</sup>	<i>Annual Report</i>	<i>Liquidity, Risk and Leverage Disclosure</i>	<i>Conflicts of Interest Disclosure</i>	<i>NAV Disclosure</i>
Type of information	Pre-contractual information	Pre-contractual and ongoing information	Ongoing information	Ongoing information	Ongoing information

261. Article 75(2) of the UCITS Directive. A 'durable medium' means 'an instruments which enables an investor to store information addressed personally to that investor in a way that is accessible for future reference for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored'. In particular, it includes USB memory stocks, CD-ROMs and DVDs. See Article 2(1)(m) of the UCITS Directive.

262. Article 80(3) of the UCITS Directive.

263. Articles 75(3) and 78(4) of the UCITS Directive.

264. *Ibid.*

265. Article 76 of the UCITS Directive.

266. If the AIF is closed-end and its shares are publicly offered in the EU or admitted to trading on an EU stock exchange, a prospectus pursuant to the Prospectus Directive is required, which exempts the AIFM from publishing an AIF prospectus. See Articles 1(2)(a) and 3 of the Prospectus Directive and 61(2) of the AIFM Directive. If adopted, AIFMs will also be held to publish a KID under the PRIIP rules in case they offer their shares to retail investors as defined in Article 4(c) of the PRIIP Proposal.

	<i>AIF Prospectus</i> <sup>266</sup>	<i>Annual Report</i>	<i>Liquidity, Risk and Leverage Disclosure</i>	<i>Conflicts of Interest Disclosure</i>	<i>NAV Disclosure</i>
Timing of delivery or publication	Prior to the investment.	A recent copy is provided prior to the investment and a new version is published annually, no later than six months following the end of the financial year, and provided to investors on request. <sup>267</sup>	Periodically, as required by the AIF's rules or instruments of incorporation, or at the same time as the prospectus and offering document, at least at the same time as the annual report is made available. <sup>268</sup>	Continuously for such period of time as the investor may reasonably need to inspect it. <sup>269</sup>	Periodically, as set out in the AIF rules or instruments of incorporation and at least once a year. <sup>270</sup>
Method(s) of delivery or publication	Through the AIFM's or AIF's website, directly in paper, or electronically, with or without investors' consent and/or provided to intermediaries.	Through the AIFM's or AIF's website, directly in paper, or electronically, with or without investors' consent and/or provided to intermediaries.	Through the periodic (annual) reports of the AIF and in 'a clear and understandable way'. <sup>271</sup>	Through the AIFM's or AIF's website or any other durable medium. <sup>272</sup>	In accordance with the applicable national law and the AIF rules or instruments of incorporation. <sup>273</sup>

267. Articles 23(1)(k) and 22(1) of the AIFM Directive.

268. Articles 108(2)(b), (4), (5), and 109(1), and 109(3) of the Commission Delegated Regulation on AIFMs. However, changes to the maximum leverage employed by the AIFM and new special arrangements should be disclosed to investors immediately. Article 108(3)(b) of the Commission Delegated Regulation on AIFMs.

269. Article 36(2)(c) of the Commission Delegated Regulation on AIFMs.

270. Article 19(3) AIFM Directive.

271. Article 108(1) and (b) of the Commission Delegated Regulation on AIFMs.

272. Article 36(1) of the Commission Delegated Regulation on AIFMs.

273. Article 19(3) AIFM Directive.

As the regulatory frameworks applying to UCITS and AIFMs differ from each other on a number of aspects, most notably with respect to the information to be provided and the level of details contained in the key disclosure documents, the following subparagraphs will discuss the main (pre-contractual and ongoing) disclosure requirements applying to UCITS and AIFs separately. In this context, it can be noted that the information required to be published in the annual report of AIFs, although it can be classified as both pre-contractual and ongoing information, will be discussed in the ongoing disclosure section due to its inherent periodic nature. Furthermore, NAV disclosures are not discussed separately below, as it can be referred to section 2.6.2 for more details on this disclosure type.

### 3.7.1 Pre-contractual Disclosure Requirements for UCITS

The UCITS pre-contractual disclosure regime has been recently subject to intensive review, which led to the adoption of the KII as key information document for investors replacing the ‘simplified prospectus’. Reason for the review was the general dissatisfaction among market participations, although the financial crisis also worked as catalyst for the regulatory reform.<sup>274</sup> The new regime is part of the trend of EU regulators of a more disclosure-based approach towards financial regulations and ‘the movement of the UCITS regime from market construction, via the UCITS passport, to market regulation in the form of a sophisticated disclosure policy’.<sup>275</sup> Nowadays, UCITS must publish both a prospectus [A] and KII [B]. These documents may be available to investors before they invest in the UCITS, as a result of which they function as pre-contractual documents.

#### [A] UCITS Prospectus

Since open-end funds are exempt from publishing a prospectus under the Prospectus Directive,<sup>276</sup> the UCITS Directive forms the basis of the prospectus disclosure requirement for UCITS. Under Articles 68(1)(a) and 69(1) of the UCITS Directive, UCITS must publish a prospectus containing ‘the information necessary for investors to be able to make an informed judgement of the investment proposed to them, and, in particular, of the risks attached thereto’. Schedule A of Annex I to the UCITS Directive provides a list of minimum information that should be included in the prospectus, among which basic information about the UCITS such as its name and address, date of establishment, and information about the fund’s auditor, and detailed information on, among other things, the key characteristics of the UCITS’ shares, its investment objectives, strategies, risks and costs, valuation and redemption policies, performance, and information regarding the remuneration paid to directors and managers. In the prospectus, UCITS

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274. The financial crisis showed that even sophisticated investors misinterpreted investments risks on many occasions, most notably the risks of MBS.

275. Moloney, *EC Securities Regulation*, 325.

276. Article 2(a) of the Prospectus Directive (exempting ‘units issued by collective investment undertakings other than the closed-end type’ from the scope of the directive).

must furthermore provide information regarding the depositary and advisers, including material provisions which may be of relevance to investors.<sup>277</sup> In addition, the UCITS Directive requires that the prospectus mentions the categories of assets in which the UCITS invest and should contain a prominent statement about its investment policy in case the UCITS replicates a stock or debt index.<sup>278</sup>

The prospectus of a feeder UCITS must contain certain disclosures, to include a prominent statement that it is a feeder and the name of the master in which it invests 85% or more of its net assets. The prospectus must also disclose certain information in relation to the underlying master UCITS, including information with regard to the investment objective and policy of the master, aggregate charges at the level of the feeder and the master and tax implications for the feeder arising from the investment in the master.<sup>279</sup> The ‘essential elements’ of the prospectus must be kept up-to-date.<sup>280</sup>

## [B] KII

While the prospectus requirement set out in the UCITS Directive establishes extensive disclosure requirements on UCITS, the document was generally perceived to be too long and complex for the average investor to make an adequate investment decision.<sup>281</sup> Consequently, in 2001, the ‘simplified prospectus’ was introduced, which aimed at providing investors clear information on the fund key features only.<sup>282</sup> It contained a brief presentation of the UCITS ‘investment information’, including a description of its investment objectives, risk profile and historical performance, economic information regarding taxation, fees and expenses, and commercial information detailing the manner in which its shares can be bought and sold.<sup>283</sup> However, the simplified prospectus was not considered simple enough for the more ‘alternative’ or ‘structured’ UCITS that have emerged over the past decade as a result of the evolution of the global financial markets, the increasing complexity of financial products, and the expanded investment opportunities provided to UCITS by the UCITS III Product Directive.<sup>284</sup> A PwC study of 2008 noted that many UCITS use more alternative strategies and

277. See Schedule A of Annex I, under 2 and 3 to the UCITS Directive.

278. Article 70(1) and (2) of the UCITS Directive. In addition, in case of a high-volatility UCITS, the prospectus should contain a statement making notice of that fact. Upon request of investors, supplementary information regarding the risk management policy should be provided and the prospectus must contain, as an integral part of the prospectus and annexed thereto, the fund rules or instruments of incorporation. See Articles 70(3), (4) and 71 of the UCITS Directive.

279. Article 63 of the UCITS Directive.

280. Article 72 of the UCITS Directive. The directive does not state which elements are to be considered ‘essential’, i.e., fundamental to the investors’ investment decision, although it makes sense that they include, at least, the UCITS’ characteristics, investment policy, costs, and risk profile.

281. D.T. Schubauer, *Inadequacy of the UCITS Directive in a Global Marketplace*, 21:2 New York Law School Journal of International and Comparative Law 332 (2002).

282. The simplified prospectus had to be published alongside the prospectus. However, while the simplified prospectus had to be offered to investors before the conclusion of the contract, the full prospectus, annual report, and semi-annual report only had to be provided to investors upon request. See Article 13c(13) of the UCITS III Management Company Directive.

283. Schedule C of Annex I to the UCITS III Management Company Directive.

284. See about these investment possibilities section 3.2.1.

derivatives by which they ‘to a certain extent, have come to resemble hedge funds’.<sup>285</sup> As a result, ‘the risk of selling inappropriate products to clients who know too little about associated risks’ may have increased due to insufficient disclosure documents.<sup>286</sup>

In addition, under UCITS III, the form and content of the simplified prospectus was implemented by Member States in different ways. While the Commission issued a Recommendation in 2004<sup>287</sup> outlining the specific contents of the simplified prospectus, it remained merely advisory. Consequently, the rules related to the simplified prospectus were implemented by Member States different ways and some Member States established additional stringent national requirements, as a result of which the document varied in length (some prospectuses were over 10 pages), complexity and content among fund manager to fund manager.<sup>288</sup>

With the introduction of the KII by UCITS IV, it was intended to solve these problems. The aim of the KII is similar to that of the simplified prospectus: to be a short document containing key investor information in order to facilitate retail investors’ understanding of the product being offered.<sup>289</sup> However, other than the simplified prospectus, the KII also allows direct comparisons between UCITS to be made more easily and is the only document that needs to be translated into the official language of the UCITS host Member State.<sup>290</sup> The KII intends to enhance transparency and comparability through the use of a short and standardized fact sheet. CESR issued a number of guidelines to assist the industry in preparing their transition to the KII, among which a template consisting of the two-page A4 fact sheet containing minimum technical content.<sup>291</sup> CESR’s guidelines also suggest the type and size of the font to be used, the page layout and that sentences should not exceed twenty-five words.<sup>292</sup>

Alongside these guidelines, the Commission published Regulation 583/2010 concerning the KII.<sup>293</sup> The form of a regulation is chosen to ensure that the detailed

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285. PwC, *Investment funds in the European Union: Comparative Analysis of Use of Investment Powers, Investment Outcomes and Related Risk Features in Both UCITS and Non-harmonised Markets* 13 (2008).

286. *Ibid.*, 67.

287. Commission Recommendation 2004/384/EC of 27 Apr. 2004 on some contents of the simplified prospectus as provided for in Schedule C of Annex I to Council Directive 85/611/EEC, OJ L 144, 45.

288. European Commission, DG Internal Market and Services Working Document (‘Exposure Draft’), Initial orientations for discussion on possible adjustments to the UCITS Directive, 5. Simplified prospectus – Investor disclosure regime, 22 Mar. 2007, 2. The exposure draft can be found at the Commission’s website: <http://ec.europa.eu/>.

289. Article 78(1) of the UCITS Directive.

290. Articles 78(5) and 94(1)(b) of the UCITS Directive.

291. CESR’s template for the Key Investor Information document, CESR/10-1321, 20 Dec. 2010. Other guidelines include, among others, CESR, A guide to clear language and layout for the Key Investor Information document (KII), CESR/10-1320, 20 Dec. 2010, CESR’s guidelines for the transition from the Simplified Prospectus to the Key Investor Information document, CESR/10-1319, 20 Dec. 2010, CESR’s guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document, CESR/10-673, 1 Jul. 2010, and CESR’s guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document, CESR/10-674, 1 Jul. 2010.

292. CESR, A guide to clear language and layout for the Key Investor Information document (KII), 7–8.

293. Commission Regulation No. 583/2010.

content of the KII is fully harmonized and thus enables investors to better compare UCITS.<sup>294</sup> The regulation lays down the form and content of the KII and the conditions applying when providing KII or a prospectus to investors in a durable medium other than paper or by means of a website. Furthermore, it contains specific provisions related to compartments (umbrella UCITS), share classes, FoFs, feeder UCITS and structured UCITS.<sup>295</sup>

### *Form of the KII*

The regulation has been prepared in cooperation with the CESR and many of the provisions in the regulation follow the guidelines of the CESR.<sup>296</sup> For example, both CESR guidelines as the Commission Regulation state that the KII should be avoided of jargon, technical terms and should use 'clear, succinct and comprehensible' language.<sup>297</sup> Also, the length of the KII has been limited to two A4 pages and the KII must include a Synthetic Risk and Reward Indicator (SRRI), which is in essence a number between 1 and 7 which allows investors to assess the risk applicable to a potential investment in a UCITS.<sup>298</sup> A numeric value of 1 will mean a low risk/low reward investment while a 7 means a high level of risk but an equally high level of potential return.<sup>299</sup> The calculation of an SRRI will be based on the volatility of a UCITS past performance. Volatility in this context relates to fluctuations in the NAV of the UCITS, which is calculated on the basis of the weekly performance of the fund or if this data is unavailable, the monthly returns of the fund.<sup>300</sup>

For new UCITS, the management company will need to base the SRRI calculation on a representative portfolio model and simulate the projected volatility.<sup>301</sup> CESR has also set out different calculation methods for absolute return funds, total return funds, life cycle funds and structured UCITS since the historical volatility method would not suffice for these funds because of inherent frequent changes in their portfolio allocations. In most cases, the calculation of a SRRI for these funds will incorporate a VaR method due to the nature of the investment strategies involved.<sup>302</sup>

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294. Recital 2 to Commission Regulation No. 583/2010.

295. Ch. IV of Commission Regulation No. 583/2010.

296. See on the history of the KII also Moloney, *How to Protect Investors: Lessons from the EC and the UK*, 316–322.

297. Article 5(1)(b) of Commission Regulation (EU) 583/2010 and CESR, A guide to clear language and layout for the Key Investor Information document (KII), 6–7.

298. Article 6 and Annex I of Commission Regulation (EU) 583/2010, CESR's template for the Key Investor Information document and CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document.

299. Annex I of Commission Regulation No. 583/2010.

300. CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document, 5–6.

301. *Ibid.*, 12.

302. *Ibid.*, 9–15.

*Content of the KII*

CESR's KII template shows that the KII should consist of five sections that are put in separate boxes, each of them with specific requirements. The sections include: (1) objectives and investment policies, (2) risk profile, (3) charges, (4) past performance and (5) practical information.<sup>303</sup> The first section describes the objectives and the investment policy of the UCITS (and the main targeted investments) in plain language, not necessarily using the same technical language as that used in prospectuses.<sup>304</sup> In the second section, the SRRI is presented, along with a narrative explanation of the SRRI, its main limitations, and the risks materially relevant to the fund which are not adequately captured by the indicator, including credit risk, counterparty risk, liquidity risk, operational risk, and the impact of specific investment techniques such as derivatives.<sup>305</sup> The third section includes the main charges of the UCITS, which contains three sets of figures (all in percentage points): entry/exit fees, ongoing charges and 'charges taken from the UCITS under specific conditions', i.e., performance-based fees.<sup>306</sup>

With respect to these charges figures, the entry/exit fees will describe the maximum percentage of one-time charges taken out of the subscribed/redeemed amounts. Ongoing charges are payments that are deducted from the assets of the UCITS and that the UCITS would have to pay in the absence of any new purchases or sales of investments and if markets remained static through the period. The ongoing charges replaced the Total Expense Ratio (TER) required in the simplified prospectus and represents the annualized ratio of total costs related to the assets of the UCITS.<sup>307</sup> The calculation is based on a standardized methodology which identifies specific items for inclusion and exclusion.<sup>308</sup> It includes payments made to the directors, management, depositary or other service providers of the fund and the costs of acquiring and disposing fund assets.<sup>309</sup> It is broadly similar to the TER, but does not include performance-based fees, which must be disclosed separately.

The presentation of past performance includes a bar chart showing ten years (or five in specific cases) of annualized performance history (calculated following the calendar year). The past performance bar chart must be accompanied by several statements, including a warning about the limited value of the bar chart, a brief indication of charges which have been included or excluded, an indication of the year

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303. See CESR's template for the Key Investor Information document.

304. CESR explicitly suggests 'not to copy-out the prospectus'. *Ibid.*, 4.

305. *Ibid* and Article 8(5) of Commission Regulation No. 583/2010.

306. Article 10 of Commission Regulation No. 583/2010.

307. See for the TER and the included/excluded costs required under the simplified prospectus regime, Annex I to Commission Recommendation 2004/384/EC.

308. The ongoing charges figure consists of the ratio of the total discloseable costs to the average net assets of the UCITS. Costs that are to be included in the ongoing, among others, the management annual fees, fees paid to custodians and depositaries and other service providers, legal fees, registration fees and audit fees. Costs that are to be excluded include, in addition to performance-based fees, entry/exit costs, interest on borrowings, and subscription and redemption fees. See CESR's guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document, 4–6.

309. *Ibid*, under 4.

that the UCITS came into existence and an indication of the currency in which past performance has been calculated.<sup>310</sup> The calculation of the past performance figures is based on the UCITS' NAV.<sup>311</sup> Where a benchmark forms part of the UCITS investment objective and policies section, a bar showing the performance of that benchmark should be included in the chart alongside each bar showing the past performance of the UCITS.<sup>312</sup> The benchmark should not be shown for years in which the UCITS did not exist.<sup>313</sup> Structured UCITS, i.e., UCITS which are linked to price changes or other conditions of financial assets, indices or other UCITS portfolios, should use prospective scenarios, rather than the 'past performance' section of the KII.<sup>314</sup> In this context, CESR has developed guidelines which aims to ensure comparability between structured UCITS and consistency in their choice of prospective scenarios and the format of those scenarios.<sup>315</sup>

Lastly, the practical information section should include a series of relevant information regarding the fund, including: contact details, depositary, law applicable to the UCITS and where to find additional information.<sup>316</sup>

The KII must be updated as frequently as needed in order to preserve its accuracy, but at least every year.<sup>317</sup> Any material change regarding investment policy has to be promptly updated, and the same applies for a material change in the ongoing charges figure or an increase/decrease of the SRRI.<sup>318</sup> The past performance must be updated thirty-five business days after the end of the calendar year.<sup>319</sup> Any change in the charge structure that result in an increase or decrease of the maximum front-end or back-end load should be properly reflected in the charges section.<sup>320</sup> Where the ongoing charges are no longer reliable, the UCITS management company should instead estimate a figure for 'ongoing charges' that it believes on reasonable grounds to be indicative of the amount likely to be charged to the UCITS in future, which must be accompanied with a warning statement.<sup>321</sup> To prevent fund managers to simply 'tick-the-box',

310. Article 15(5) of Commission Regulation No. 583/2010.

311. Article 16 of Commission Regulation No. 583/2010.

312. Article 18(1) of Commission Regulation No. 583/2010.

313. Article 18(2) of Commission Regulation No. 583/2010.

314. Article 36(1) of Commission Regulation No. 583/2010. Structured UCITS are, for the purpose of the regulation, defined as 'UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features'. *Ibid.*

315. CESR's guidelines on the selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS, CESR/10-1318, 20 Dec. 2010.

316. Article 20 of Commission Regulation No. 583/2010.

317. Article 22(1) of Commission Regulation No. 583/2010. The KII must be presented by investors by using a durable medium, which may be in a format other than paper provided certain conditions are met. *See* Article 38 of Commission Regulation No. 583/2010.

318. Article 22(2) and (3) of Commission Regulation No. 583/2010.

319. Article 23(3) of Commission Regulation No. 583/2010.

320. Article 24(1) of Commission Regulation No. 583/2010.

321. Article 24(2) of Commission Regulation No. 583/2010. The following statement should be disclosed: 'The ongoing charges figure shown here is an estimate of the charges. [Insert short description of why an estimate is being used rather than an ex-post figure.] The UCITS' annual report for each financial year will include detail on the exact charges made'. *Ibid.*

Article 79(1) of the UCITS Directive requires that the KII must be ‘fair, clear and not misleading’ and be ‘consistent with the relevant parts of the prospectus’.

### *Specific Provision regarding the KII*

Regarding specific operational structures that may be adopted by UCITS, the following observations can be made with respect to the KII. A UCITS umbrella structure will need to produce a KII for each sub-fund and potentially some share classes within a sub-fund may require a separate KII or SRRI, e.g., in the case of ‘hedged’ share classes.<sup>322</sup> UCITS FoFs or feeder funds must also publish a KII and the document must include, in the case of an FoF, a description on how the underlying funds are selected and the risk factors of the underlying funds or, in the case of a feeder, the proportion of the fund’s assets invested in the master, the master’s investment policy and whether the investment return will differ from that of the master.<sup>323</sup> In addition, feeder UCITS must provide some practical information about the master fund and describe whether the risk and reward profile differs from the master fund.<sup>324</sup> The charges section of the KII of a UCITS FoF or feeder fund must include the fees paid to the underlying funds or the master fund.<sup>325</sup>

### *Success of the KII*

Despite the extensive effort to achieve maximum harmonization of key information regarding UCITS, caution is required. Almost 30% of the respondents of the KPMG ‘Perfect UCITS’ study note that the information in the KII could still be improved. Most notably, it has been mentioned that the average retail investor may not know that the management fee includes a fee for the distributor of the fund.<sup>326</sup> In addition, the respondents state that there is an over-reliance among investors on the SRRI. This is, according to the respondents, due to its visual representation and the fact that the KII does not provide enough space to explain the underlying strategy and objective of the

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322. Articles 25(1) and 26(1) and (2) of Commission Regulation No. 583/2010. A UCITS management company may select a class to represent one or more other classes of the UCITS, provided the choice is ‘fair, clear and not misleading to potential investors in those other classes’. Furthermore, an umbrella UCITS that publishes only one KII must ensure that: (1) the ‘Risk and Reward Profile’ section of the KII contains an explanation of material risks applicable to other share classes being represented, (2) the ‘Practical Information’ section of the KIID includes details of the representative share class, (3) the UCITS keeps a record of the other classes are represented by the representative share class and the grounds for selection of this share class, and (4) specific features of different share classes are selected and combined into a mixed profile of a representative share class. See Article 26(3), (4) and (5) of Commission Regulation No. 583/2010.

323. Articles 28, 29 and 31 of Commission Regulation No. 583/2010.

324. Articles 32 and 34 of Commission Regulation No. 583/2010. Feeder UCITS may not publish the performance records of the master funds, unless it is showed as a benchmark or when a ‘a simulated performance’ of the master or, in case it has a performance record from before it was a feeder, its own record, is shown. See Article 35 of Commission Regulation No. 583/2010.

325. Articles 30 and 33 of Commission Regulation No. 583/2010.

326. KPMG, *The Perfect UCITS*, 12.

fund in simple terms.<sup>327</sup> Investors that base their investment decision solely on the SRRI thus may not be informed sufficiently.

It is interesting to note that, if almost one-third of the questioned fund managers, who have an incentive to sell fund shares, state that KII is insufficient: how bad are things really?<sup>328</sup> Furthermore, the question can be raised whether the KII is really a comparable document that is understandable to investors as no evidence has been provided by the Commission as to whether the KII model on itself supports specific decision-making outcomes.<sup>329</sup> In this context, it can be noted that the proposed PRIIP rules may provide for new disclosure documents for UCITS in the future. If adopted, the rules would require each PRIIP, including UCITS, to publish a Key Information Document (KID) so that retail investors are able to compare different types of retail investment products.<sup>330</sup> UCITS are however excluded for at least five years from the KID rules, subject to a review by the Commission after four years to decide whether to continue those transitional arrangements or whether to align the KII under the UCITS Directive with the PRIIP KID.<sup>331</sup> The KID will differ from the UCITS KII on a number of points. So will the KID be expected to contain answers to a set of standardized questions, including: ‘What is this product? What are the risks and what could I get in return? What are the costs?’<sup>332</sup> Furthermore, it will contain information on the direct

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327. *Ibid.*, 23.

328. Although on the other hand, not surprisingly, 90% of the respondents are against a ban on performance-based fees, which may stimulate short-termism among fund managers and are often not clearly disclosed to investors. Performance-based fees have nevertheless been placed high on the agenda of the Commission and the topic is included in both the AIFM and UCITS V. *Ibid.*, 13.

329. Willemaers, *The EU Issuer-Disclosure Regime: Objectives and Proposals for Reform*, 214. The Commission has been provided with a research performed by IFF Research Ltd and YouGov in which the content of the KII was tested to determine whether the areas that had been identified were the right areas for the KII and whether there were any important omissions. However, the research only includes qualitative results as to whether the KII will engage the retail investor’s attention in the decision-making process and found that ‘very few consumers who studied [the new KII documents] understood every word and concept of the content’ and that many retail investors appear to use the KII as a ‘good introduction to the fund and a means of arming themselves with questions to ask a financial advisor’ [rather than basing their investment decisions on]. IFF Research and YouGov, *UCITS Disclosure Testing Research Report – Prepared for European Commission* 18 & 147 (June 2009). The report can be found at the Commission’s Internal Market website: [http://ec.europa.eu/internal\\_market/](http://ec.europa.eu/internal_market/).

330. Recital 11 to the PRIIP Proposal (stating that ‘[r]etail investors should be provided with the information necessary for them to take an informed investment decision and compare different PRIIPs’).

331. In the impact assessment on the Commission’s initial PRIP proposal (an additional ‘I’ was introduced during the legislative negotiations to include insurance-based investment products in the scope of the regulation), the Commission has concluded that given the recent introduction of the UCITS KII, it would not be proportionate to apply the KID requirements to UCITS at first stage. See Impact assessment on the PRIP proposal, SWD(2012) 187, 3 Jul. 2012, 56. After four years, the Commission will assess how UCITS should be treated and whether the existing KII should be amended. Besides adjusting the KII framework, it may also be possible to: (1) prolong the transitional period, (2) move the substantive rules on the disclosure for UCITS to the PRIIP regulation, or (3) establish that the KII is equivalent to the PRIPs KID. See Proposal for a Regulation of the European Parliament and of the Council on key information document for investment products, COM(2012) 352 final, 2 Jul. 2012, 10.

332. Article 8(3)(b), (c) and (e) of the PRIIP Proposal.

and indirect costs of the product, while the KII only includes information on the charges, including exit/entry fees, ‘ongoing charges’ and performance-based fees. However, it is not yet clear how far the cost section in the KID is intended to extent and whether UCITS will be required to disclose more costs under the KID than the current KII.<sup>333</sup> ESMA guidelines clarifying these and other issues regarding the PRIIP rules will be needed.<sup>334</sup>

### 3.7.2 Ongoing Disclosure Requirements for UCITS

The ongoing disclosure requirements applying to UCITS require them to publish an annual report for each financial year and a half-yearly report covering the first six months of the year. The reports provide investors with the information to help them judge whether the UCITS is being managed in the way they have been promised and whether it is still appropriate for their investment needs. According to Article 69(3) of the UCITS Directive, the annual report must contain a balance sheet or statement of assets and liabilities, a detailed income and expenditure statement, a report on the activities during the financial year, information provided for in Schedule B of Annex I to the directive, and any other significant information to enable investors to make an informed judgments of the development of the activities of the UCITS. Schedule B of Annex I to the directive sets out detailed information that the annual report must include. So should the statement of assets and liabilities include the following items: ‘transferable securities’, ‘bank balances’, ‘other assets’, ‘total assets’, ‘liabilities’, and ‘net asset value’.<sup>335</sup> Furthermore, the income and expenditure statement should include, among other things, the following items: ‘income from investment’, ‘management charges’, ‘depository’s charges’, ‘other charges and taxes’, ‘transaction costs’, and ‘distributions and income reinvested’.<sup>336</sup> Other information included in the annual report includes: the NAV per share, the number of shares in circulation, a comparative table comparing the total NAV and the NAV per share of the last three years, information on the fund’s portfolio composition, and details of the resulting number of commitments.<sup>337</sup>

The half-yearly report is less detailed than the annual report, although it must still contain information such as the balance sheet, the number of shares in circulation, the NAV per share, and other information relating to the portfolio of the fund. Furthermore

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333. Article 8(3)(e) of the PRIIP Proposal only provides that direct and indirect costs comprise of ‘one-off and recurring costs, presented by means of summary indicators of these costs, and, to ensure comparability, total aggregate costs expressed in monetary and percentage terms, to show the compound effects of the total costs on the investment’. Furthermore, it provides that distribution costs or costs paid to other service providers should be mentioned separately in the KID in case they are not included in the general direct and indirect cost section ‘to enable the retail investor to understand the cumulative effect that these aggregate costs have on the return of the investment’.

334. See also Article 8(5)(c) of the PRIIP Proposal.

335. Schedule B of Annex I, under I to the UCITS Directive.

336. Schedule B of Annex I, under V to the UCITS Directive.

337. Schedule B of Annex I, under II, III, IV, VI and VII to the UCITS Directive.

where the fund opts to pay an interim dividend, the figures must indicate the results after tax for the half-year concerned and the interim dividend paid or proposed.<sup>338</sup>

UCITS FoFs must disclose the business of the underlying funds in which they invest in the annual and half-yearly report and the maximum proportion of management fees charged both to the UCITS itself and to the underlying funds.<sup>339</sup> The statement on the aggregate charges of a feeder UCITS and master UCITS must be included in the annual report of the feeder UCITS and in both the annual and half-yearly report it must be indicated how the annual and the half-yearly report of the master UCITS can be obtained.<sup>340</sup> Feeder UCITS must also provide investors -free of charge and on request- with a copy of the annual and half-yearly reports of the master UCITS.<sup>341</sup> 'Index-tracking UCITS'<sup>342</sup> should, according to ESMA guidelines, provide additional information in their annual and half-yearly reports (and prospectus and KII), including the size of the tracking at the end of year/half-year, an explanation of any divergence between the anticipated and realized tracking error for the relevant period, and (only in the annual report) the annual tracking difference between the performance of the UCITS and the performance of the index tracked.<sup>343</sup>

The UCITS Directive does not require UCITS to publish any other marketing materials than the prospectus, KII and annual and half-yearly reports. It only requires, in addition to the mandatory disclosure documents, that UCITS must publish 'in an appropriate manner' (e.g., on its website) the issue, sale, repurchase or redemption price of its shares each time it issues, sells, repurchases or redeems them, and at least twice a month.<sup>344</sup> With respect to marketing documents issued by UCITS, recital 58 to the directive provides that 'Member States should make a clear distinction between marketing communications and obligatory investor disclosures provided for under this Directive'. Marketing materials that are not required under the directive may be subject to national marketing rules provided that they are non-discriminatory and do not

338. Article 69(4) of the UCITS Directive and Schedule B of Annex I, under I to IV to the UCITS Directive.

339. Articles 50(1)(e)(iii) and 55(3) of the UCITS Directive.

340. Article 63(2) of the UCITS Directive.

341. Article 63(5) of the UCITS Directive.

342. An 'Index-tracking UCITS' is '[a] UCITS the strategy of which is to replicate or track the performances of an index or indices e.g., through synthetic or physical replication'. See ESMA, Report and Consultation paper: Guidelines on ETFs and other UCITS issues – Consultation on recallability of repo and reverse repo arrangements, 43.

343. *Ibid.*, 44 (under 11). The additional information provided in the prospectus includes: (1) a description of the indices including information on their underlying components, (2) information on how the index will be tracked and implications of the chosen method for investors, (3) information on the anticipated level of tracking error in normal market conditions, and (4) description of factors that are likely to affect the ability of index-tracking UCITS to track the performances of the indices, such as transaction costs, small illiquid components, dividend re-investment etc. Information on how the index will be tracked and implications of the chosen method for investors should also be included in a summary form in the KII of the index-tracking UCITS. See *ibid.*, under 10 & 11.

344. Article 76 of the UCITS Directive. The competent authorities may permit a UCITS to publish this information only once a month on the condition that this does not conflict with the interests of investors. *Ibid.*

prevent UCITS from accessing the market.<sup>345</sup> The fact that these documents are not harmonized may result in complex, technical and duplicative disclosure that do not help (or, on the contrary, may even prevent) investors from making an informed investment decision. The UCITS Directive tries to prevent abuse by summarizing the key aspects of marketing rules: all marketing communications (whether mandatory under the directive or not) should be ‘fair, clear and not misleading’.<sup>346</sup> Also, non-mandatory marketing communications must be consistent with prospectus and KII disclosure and must state that a prospectus and KII exists and how investors can obtain them.<sup>347</sup>

In addition to this ‘principle-based’ rule, the UCITS Directive provides some explicit requirements on marketing communications of certain specific UCITS types. For example, with respect to feeder UCITS, it requires such UCITS to disclose in any relevant marketing communication document that it permanently invests 85% or more of its assets in a master UCITS.<sup>348</sup> Furthermore, index-tracking UCITS should include a statement in their prospectus and any other marketing communications making notice of their specific investment policy and techniques used.<sup>349</sup> However, despite these provisions, the UCITS Directive leaves significant space to Member States related to the format and contents of other marketing communications than those obliged under the directive.

### 3.7.3 Pre-contractual Disclosure Requirements for AIFMs

Article 23 of the AIFM Directive lists a wide range of investor disclosures to be made prior to investment. These disclosures will be generally made in the AIF prospectus, although in some cases it is appropriate to include them in the annual report as part of the periodic or regular reporting requirements (see section 3.7.4).

The information that must be disclosed to investors is set out in Article 23(1) and (2) of the directive. This article nor any additional regulation or ESMA guidance prescribes a format for the disclosure, although national Member States may impose certain requirements on AIFMs regarding to the format and lay out of the disclosure document (or impose other, additional disclosure requirements).<sup>350</sup> The disclosure should only be done to prospective investors of each EU AIF the AIFM manages and for each AIF that it markets in the EU: public disclosure is not required (as opposed to the

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345. Recital 64 of the preamble to the UCITS Directive (stating that ‘this Directive should not prevent the competent authorities of the host Member State from verifying that marketing communications, not including key investor information, the prospectus and annual and half yearly reports, comply with national law before the UCITS can use them, subject to such control being non-discriminatory and not preventing that UCITS from accessing the market’).

346. Article 77 of the UCITS Directive.

347. *Ibid.*

348. Article 63(4) of the UCITS Directive.

349. Article 70(2) and (3) of the UCITS Directive.

350. In case these requirements are only imposed on AIFMs that market AIF shares to retail investors, they may however not impose stricter or additional requirements on EU AIFs established in another Member States than on local AIFs. See Article 43(1) of the AIFM Directive.

UCITS prospectus). The AIFM Directive does not impose any translation requirements on the prospectus.

Article 23(1) of the AIFM Directive provides for a similar set of disclosures that must be made at the pre-contractual stage as those contained in the UCITS prospectus and/or KII. So must AIFMs disclose information about the AIF with respect to its investment strategies and objectives, including the procedures by which it may change its strategy and/or policy, the assets in which it invests, risk profile, the circumstances under which it may employ leverage, the types and sources of leverage permitted, the maximum level of leverage it may employ on behalf of the AIF, and restrictions on the use of leverage and collateral arrangements, and (if applicable) its master or underlying funds.<sup>351</sup> Other information that must be disclosed to investors before they invest in the AIF include:

- A description of the main legal implications of the contractual relationship (information on jurisdiction, applicable law, etc.).
- The identity of the service providers (AIFM, depositary, valuer, auditor, prime broker etc., their obligations, including depositary liability and investors' rights).
- A description and the identity of any delegated manager or delegated depositary and potential conflicts of interest that may arise from the delegation.
- A description of how the AIFM complies with the capitalization requirements.
- All fees and expenses to be borne by investors.
- Provisions to ensure fair treatment of investors, together with details of any preferential treatment.<sup>352</sup>
- Valuation procedures.<sup>353</sup>
- The latest NAV, procedure for the issue and sale of shares, and historical performance information where available.
- The latest audited annual reports within six months of the year end date.
- Liquidity management procedures, including how subscriptions and redemptions are processed.<sup>354</sup>

'Material changes' to any of the disclosures under Article 23 must be addressed in the annual report.<sup>355</sup> A material change has been defined as 'changes in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including for reasons that such information could impact an investor's ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors in the

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351. Article 23(1)(a) and (b) of the AIFM Directive.

352. See on the basic standards of conduct applying to AIFMs, including the general duties of loyalty and care, section 3.8.

353. See on the valuation of AIF assets and the valuation policies that AIFMs must adopt, section 3.4.4.

354. Article 23(1)(c)-(o) of the AIFM Directive.

355. Article 22(2)(d) of the AIFM Directive.

AIF'.<sup>356</sup> Material changes should be disclosed in line with the requirements of the accounting standards and accounting rules adopted by the AIF together with a description of any potential or anticipated impact on the AIF and/or investors of the AIF.<sup>357</sup>

While the information that must be provided to investor on an initial base seems to be excessive, the disclosure is, as stated, form-free and subject to much less detailed requirements than the UCITS disclosure documents or prospectus requirements under the Prospectus Directive.<sup>358</sup> AIFMs have the freedom to decide whether an AIF prospectus is provided to investors and, if so, how the prospectus is published. If they choose not to publish a separate prospectus document, they can provide the required information on their website as long as the information is 'clear, readable understandable, and clearly presented, whereas the usefulness of the information is enhanced when it is comparable from AIFM to AIFM and AIF to AIF and from one period to the next'.<sup>359</sup> This point of view is similar to the general aim of the KII for UCITS, but thus without the imposition of standardization regarding the exact form and contents of the disclosure. Although this freedom may be beneficial to the AIFM sector, the pre-sale disclosure requirements set out in the AIFM Directive did not put an end to the existing differences among Member States regarding pre-contractual investor disclosure.<sup>360</sup>

An example of where such differences may arise concerns costs disclosure. While the AIF prospectus (or information provided on the AIFM's or AIF's website) must contain a description of all fees and expenses directly or indirectly paid by investors and the maximum amounts thereof, it does not state how these costs should be disclosed. So may AIFMs only provide the total aggregated percentage or amount of costs and fees payable by investors or split those costs into item categories and disclose each category separately to investors. This may result in cost disclosures that 'bury' the underlying performance fees and soft dollar arrangements for investors. Nevertheless, since the disclosure requirements of Article 23 are mandatory, they still create an additional cost burden for AIFMs compared to the pre-AIFM Directive stage. According to research performed by Deloitte in 2012, 17% of the respondents rated the cost of disclosure compliance as 'considerable' and 12% as 'high' or 'major'.<sup>361</sup> A 2013 joint KPMG, AIMA and Managed Funds Association (MFA) research shows a more dramatic standpoint, as almost half of its respondents rated the cost of compliance as 'high' and

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356. Article 106 of the Commission Delegated Regulation on AIFMs.

357. Article 22(3) of the AIFM Directive.

358. Cf., Article 23 of the AIFM Directive and, e.g., Annex I to Commission Regulation (EC) No. 809/2004 of 29 Apr. 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements, OJ L 149, 1 and Schedule A of Annex I to the UCITS Directive.

359. Recital 124 of the Commission Delegated Regulation on AIFMs.

360. Zetsche, *The Alternative Investment Fund Manager Directive*, 335. See for an overview of the different implementation measures of the AIFM disclosure rules in EU Member States L. van Setten & D. Busch, *Alternative Investment Funds in Europe – Law and Practices* (Oxford U. Press 2014).

361. Deloitte, *Responding to the New Reality: Alternative Investment Fund Managers Directive Survey 20* (July 2012). The research can be found at Deloitte's website: <http://www.deloitte.com/>.

a further third (33%) as ‘medium’, although the ‘costs of compliance’ section in the research includes both authorization and disclosure requirements.<sup>362</sup>

### 3.7.4 Ongoing Disclosure Requirements for AIFMs

In addition to the AIF prospectus, AIFMs should comply with a number of ongoing disclosure requirements. According to Article 22(1) of the AIFM Directive, AIFMs are required to publish, for each EU AIF they manage and for each AIF they market in the EU, an annual report. AIFMs are not required to publish half-yearly reports. In general, the report must be presented in a manner that provides ‘materially relevant, reliable, comparable and clear information’ that investors need to understand the particular AIF structure.<sup>363</sup> In particular, it should contain a balance sheet or statement of assets and liabilities, an income and expenditure statement, a report on the activities during the financial year, material changes in the pre-contractual investor information (see above), the total amount of remuneration split into fixed and variable remuneration (which should also mention the carried interest paid by the AIF), and the aggregated amount of remuneration broken down by senior management and staff of the AIFM that have a material impact on the risk profile of the AIF.<sup>364</sup>

The Commission Delegated Regulation on AIFMs provides for additional, minimum rules related to the information included in the annual report.<sup>365</sup> For example, the regulation, which is to a large extent based on ESMA advice,<sup>366</sup> requires that the balance sheet or statement of assets and liabilities should contain an ‘assets’ section, comprising the AIF’s ‘investments’, ‘cash and cash equivalents’, and ‘receivables’, a ‘liabilities’ section, comprising of the AIF’s ‘payables’, ‘borrowings’, and ‘other liabilities’, and a ‘net assets’ section, representing the residual interest in the assets of the AIF after deducting all its liabilities.<sup>367</sup> The income and expenditure statement should represent ‘any increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets other than those relating to contributions from investors’.<sup>368</sup> Furthermore, it should contain, among other things, an ‘investment income’ section,

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362. KPMG/AIMA/MFA, *The Cost of Compliance* 10 (2013). The research can be found at KPMG’s website: <http://www.kpmg.com/>.

363. See Article 103 of the Commission Delegated Regulation on AIFMs.

364. Article 22(2) of the AIFM Directive.

365. It provides for ‘key elements and a non-exhaustive list of items’ providing for minimum standards with respect to annual reporting requirements. See recital 125 of the Commission Delegated Regulation on AIFMs. The annual report should furthermore be prepared in accordance with the accounting standards of the home Member State or of the third country where the AIF is established, the accounting rules laid down in the AIF rules of instruments or incorporation and the ‘internationally accounting standards’. Furthermore, where applicable, it should comply with the accounting rules set out in the Transparency Directive. See Article 22(3) of the AIFM Directive.

366. ESMA, Final Report – ESMA’s technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive.

367. Article 104(1) of the Commission Delegated Regulation on AIFMs.

368. Article 104(2)(a) of the Commission Delegated Regulation on AIFMs.

including the AIF's 'dividend income', 'interest income', and 'rental income', and the AIF's realized and unrealized gains and losses.<sup>369</sup>

For the report of the financial activities of the AIF, the regulation provides that it should contain at least: (a) an overview of investment activities during the year or period and of the AIF's portfolio at year-end or period end, (b) an overview of AIF performance over the year or period, and (c) material changes in the information listed in Article 23 of the AIFM Directive not already presented in the financial statements.<sup>370</sup> The report of the financial activities should also include a 'fair and balanced' review of the activities and performance of the AIF, and description of principal risks and investment or economic uncertainties that the AIF may face.<sup>371</sup> Where necessary, analysis should include both financial and (where applicable) non-financial key performance indicators relevant to the AIF.<sup>372</sup>

Lastly, with respect to remuneration disclosure, the regulation requires that the annual report should specify to who the total remuneration relates. In this context, the AIFM can choose between three options: (1) the total remuneration of the entire staff of the AIFM, (2) the total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF, or (3) the proportion of the total remuneration of staff of the AIFM attributable to the AIF.<sup>373</sup> The total remuneration should also concern any carried interest paid and AIFMs shall provide general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff.<sup>374</sup> See with respect to requirements on the adoption of a remuneration policy by AIFMs, section 3.4.5[B].

In addition to the annual reporting requirement, AIFMs are subject to a number of other periodic disclosure requirements. These requirements can be divided into: (1) liquidity disclosures, (2) risk disclosures, (3) leverage disclosures, and (4) conflicts of interest disclosures.<sup>375</sup>

With respect to liquidity disclosures, AIFMs are required to disclose to investors the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature and any new arrangements managing the liquidity of the AIF. Special arrangements are 'arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impact the specific redemption rights of investors in a type of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors'.<sup>376</sup> This includes 'side pockets'<sup>377</sup> and other mechanisms where certain assets of the AIF are subject to similar

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369. Article 104(2)(a) and (b) of the Commission Delegated Regulation on AIFMs.

370. Article 105(1) of the Commission Delegated Regulation on AIFMs.

371. Article 105(2) of the Commission Delegated Regulation on AIFMs.

372. Article 105(3) of the Commission Delegated Regulation on AIFMs.

373. Article 107(1) of the Commission Delegated Regulation on AIFMs.

374. Article 107(2) and (4) of the Commission Delegated Regulation on AIFMs.

375. Articles 14(2), 23(4) and (5) of the AIFM Directive.

376. Article 1(5) of the Commission Delegated Regulation on AIFMs.

377. Side pockets are separate accounts to which a percentage of fund assets are allocated for investments that differ from the main objective of the fund. A side pocket is treated separately for purposes of calculating the annual incentive allocation, the management fees, and for purposes of subscriptions and redemptions. In general, there is an unlimited lock-up period

arrangements between the AIF and its investors, such lock-up periods for redemptions and ‘gates’.<sup>378</sup> The AIFM should provide an overview of any special arrangement in place, the valuation methodology applied to assets which are subject to such arrangements and how management and performance fees apply to these assets.<sup>379</sup>

The risk disclosure requirements relates to the risk profile of the AIF. The AIFM must disclose periodically the measures to assess any sensitivity in the AIF portfolio to the ‘most relevant risks’ to which the AIF is, or could be, exposed, including where risk limits set by the AIFM have been, or are likely to be, exceeded.<sup>380</sup> The Commission Delegated Regulation on AIFMs however does not state which risks are considered to be ‘most relevant’ as this is left up to the AIFM to decide and will depend on the specific type of AIF it manages. This requirement is in line with the principle of differentiation, recognizing the diversity of AIF models.<sup>381</sup> In case the risk limits have been exceeded the disclosure should additionally include a description of the circumstances and, where applicable, the remedial measures taken.<sup>382</sup> The main features of the risk management systems implemented by an AIFM, including changes regarding these features and their impact on investors, must also be disclosed periodically to investors.<sup>383</sup>

Thirdly, with respect to leverage disclosure, the Commission Delegated Regulation on AIFMs provides that if an AIFM employs leverage, it must on a regular basis disclose any change to the maximum level of leverage permitted as well as any re-hypothecation rights or any guarantee granted under the leveraging arrangement and the total amount of leverage that it employs.<sup>384</sup>

Lastly, besides the above mentioned periodic disclosures, AIFMs are held disclose material conflicts of interest that arise in the course of managing AIFs to investors.<sup>385</sup> See on the examples of conflicts that must be disclosed to investors and the conflict of interest policies that should be adopted by AIFMs to identify, monitor and manage these conflicts, section 3.4.1.

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such that investor withdrawals are permitted only to the extent that the illiquid assets held in the side pocket are sold. *See* Bevilacqua, *Convergence and Divergence: Blurring the Lines between Hedge Funds and Private Equity Funds*, 264.

378. Gates limit the percentages of fund capital that can be withdrawn at a specific redemption date. *Ibid.*, 263, n. 86.

379. Article 108(2)(a) of the Commission Delegated Regulation on AIFMs.

380. Article 108(4)(a) of the Commission Delegated Regulation on AIFMs.

381. ESMA, Final Report – ESMA’s technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 232.

382. Article 108(4)(b) of the Commission Delegated Regulation on AIFMs.

383. Article 108(5) of the Commission Delegated Regulation on AIFMs. *See* on the risk management systems that AIFMs must implement, section 3.4.2.

384. Article 109(1) and (2) of the Commission Delegated Regulation on AIFMs. *See* on the limits on the level of leverage that an AIFM may employ with respect to the de minimis exemption, section 3.3.2[B].

385. Articles 14(1) and (2) of the AIFM Directive and 36 of the Commission Delegated Regulation on AIFMs.

### 3.8 CONDUCT OF BUSINESS RULES

In the EU regulatory landscape, the concept of ‘conduct of business rules’ was firstly introduced in the MiFID, which regulates firms providing investment services. The key objectives of the original MiFID were (and still are) ‘to provide for the degree of harmonisation needed to offer investors a high level of protection and to allow investment firms to provide services throughout the Community’.<sup>386</sup> One of the objectives of the MiFID is thus the protection of investors. In the proposal of the original MiFID, conduct of business rules were described as one of the ‘the mainstays of investor protection’.<sup>387</sup> Hence, it was viewed that the imposition of certain conduct of business rules on investment service providers contributes, in part, to the creation of a high level of investor protection.

The new MiFID (MiFID 2), adopted in 2014 and to be transposed into national laws in 2016, strengthened the existing conduct of business rules for investment service providers in light of the ‘continuous relevance of personal recommendations for clients and the increasing complexity of services and instruments’.<sup>388</sup> Certain rules of the MiFID conduct of business regime, which is formed by the general duty of loyalty and care, were applied to UCITS under the UCITS III Management Company Directive. Reason for this was to ensure a level playing field in the management of individual portfolios, whether managed by a MiFID firm or UCITS management company.<sup>389</sup> With the adoption of the AIFM Directive, again certain aspects of the MiFID conduct of business regime were used to constitute the business principles applying to AIFMs.<sup>390</sup>

Under the UCITS Directive, a UCITS management company (or UCITS in case of a self-managed fund) should act honestly, fairly, with due skill and care and in the best interest of the UCITS it manages.<sup>391</sup> The rules of conduct applying to AIFMs rely heavily on those applying to UCITS and only provide for certain adjustments for AIFs that are closed-end and invest in other assets than liquid assets.<sup>392</sup> Similar to UCITS management companies, AIFMs are required to ‘act honestly, with due skill, care and diligence

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386. Recital 2 of Directive 2004/39/EC of the European Parliament and of the Council of 21 Apr. 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 96/6/EEC and Directive 2000/12/EEC of the European Parliament and Council and repealing Council Directive 93/22/EEC, OJ L 145, 1.

387. Proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC, COM(2002) 625 final, 19 Nov. 2002, OJ C 71/E, 82.

388. Recital 70 of the MiFID 2.

389. A. Leclair, *Pouring Old Wine into New Skins?: UCITS & Asset Management in the EU After MiFID: A CEPS-ECMI Task Force Report 52* (CEPS 2008).

390. M. Pinedo & I. Walter (eds), *Global Asset Management: Strategies, Risks, Processes, and Technologies* 295 (Palgrave Macmillan 2013).

391. Article 14(1)(a) and (b) of the UCITS Directive.

392. ESMA, Final report – ESMA’s technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 39 (‘The “conduct of business rules” of Article 12(1) of the AIFMD correspond to a large extent to the “conduct of business rules” of Article 14(1) of the UCITS Directive’, but since ‘the UCITS provisions are tailored for open-ended investment funds that generally invest in financial

and fairly in conducting their activities’, act in the best interest of the AIFs or the investors of the AIFs they manage (in case there is no legal form established) and treat all AIF investors fairly.<sup>393</sup> By imposing these conduct of business rules on fund managers, EU regulators in essence codified the general fiduciary duties of loyalty and care that originally developed as part of the law of agency in common law jurisdictions.<sup>394</sup>

The duty of loyalty in the context of fund (asset) management can be defined as a duty to refrain from self-interested behaviour on the part of the fund manager, both as regard the manager’s own interests and the interests of other clients.<sup>395</sup> It encompasses a range of other subduties, including the duty of confidentiality and the duty to act in the best interest of investors.<sup>396</sup> The duty of care can be summarized as a duty to always do what any reasonable fund manager would do in the same situation.<sup>397</sup> As mentioned, with the adoption of the conduct of business rules for fund managers that operate in the EU, it was aimed to create unifying principles that govern financial investment intermediaries’ relationships with their clients. However, as some of these principles are already included, at least implicitly, in the contract between the investor and the fund manager, the directives have only reinforced these duties by elevating them into regulatory norms.<sup>398</sup> In addition, in some Member States, civil law judges may have laid upon financial institution, including fund managers, more far-reaching special duties of care than pursuant under the applicable financial laws.<sup>399</sup> However, the effectuation of this duty of care varies depending on the circumstances of the case, as a result of which no general duty of care under national (Member State) civil law can

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instruments, the [ESMA] advice provides adjustments or exemptions for those AIFs that are not open-ended and invest in other assets than financial instruments’).

393. Article 12(1)(a), (b) and (f) of the AIFM Directive.

394. Van Setten, *The Law of Institutional Investment Management*, 83 & 98 (‘In the case of investment management agreements, the main source of implied duties on the manager (...) is the law of agency’ and ‘[a] discretionary authority to use agency powers is normally characterized as a fiduciary responsibility and therefore, the exercise of the agency powers is subject to the principles that apply to the exercise of fiduciary responsibilities’). See for more on the agency relationship in the context of US fiduciary law, section. 4.9.1.

395. T. Spangler, *The Law of Private Investment Funds* 89 (2nd ed., Oxford U. Press 2012).

396. *Ibid.*, 91 (referring to the duty of confidentiality as one of the duties owed by a fiduciary under the duty of loyalty, where ‘a fiduciary must only use information obtained in confidence from his customer for the benefit of that customer’) and B.J. Richardson, *Fiduciary Law and Responsible Investing: In Nature’s Trust* 117 (Routledge 2013) (stating that ‘the duty of loyalty has tended to be interpreted as going beyond the basic proscriptive duty to encompass also a positive obligation to act in the best interests of beneficiaries’).

397. Spangler, *The Law of Private Investment Funds*, 87 (‘In the financial services area, the legal standard against which an investment manager would be held is the level of care and prudence that the ordinary skilled person in that field would use in such circumstances’).

398. R. Helm, *Practitioner’s Guide to Conflicts of Interest in the Financial Services Industry* 135 (Sweet & Maxwell 2012).

399. See in the context of banks, e.g., Dutch Supreme Court, 26 Jun. 1998, NJ 1998, 660 (Van de Klundert/Rabobank) and Dutch Supreme Court, 23 Dec. 2005, NJ 2006, 289 (Safe Haven). The Dutch Supreme Court imposes a special duty of care towards clients on account of their existent contractual relationship as well as towards third parties whose interests they ought to take into account under unwritten law. This civil law duty of care has been expanded to other financial institutions, including investment funds. S.B. van Baalen, *De bijzondere zorgplicht bij financiële contracten*, 4 Contracteren 75 (2006).

be extracted.<sup>400</sup> Consequently, these civil law duties will not be discussed separately in this book. Investors should however use the (contractual or civil law) remedies under national law in case one of the conduct of business duties set out in the UCITS or AIFM Directive is breached since the provision of the directives cannot be enforced in disputes between private parties.<sup>401</sup>

Below, the two general conduct duties that are set out in the UCITS Directive and the AIFM Directive will be discussed.

### 3.8.1 The Duty of Loyalty

The duty of loyalty has been expressed in Articles 14(1)(a) of the UCITS Directive and 12(1)(a) and (b) of the AIFM Directive as a duty of the UCITS management company/ AIFM to act honestly, fairly and in the best interest of the UCITS or AIF and the integrity of the market. In addition, it is determined that managers should try to ‘avoid conflicts of interests’ and ‘employ effectively the resources and procedures that are necessary for the proper performance of its business activities’.<sup>402</sup> These latter two duties, i.e., the duty to avoid conflicts and the duty not to make secret profit, can be seen as fundamental aspects of the core duty of loyalty since they serve the purpose of acting loyally and fairly towards investors.<sup>403</sup> Furthermore, UCITS management companies and AIFMs must establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question.<sup>404</sup> This so-called duty of confidentiality, which is also often included in professional codes of ethics, relates to client information and information regarding to transactions. It not only intends to serve the interests’ of investors, but also to help to prevent market abuse.<sup>405</sup>

In sum, the duty of loyalty under the two fund directives includes a number of subduties, including the duty to act in the best interest of investors, the duty of confidentiality, and the duty to avoid conflicts. Below, the first two duties, i.e., [A] the duty to act in the best interest of investors and [B] the duty of confidentiality, will be discussed in more detail. With respect to the duty to avoid conflicts, also known as the ‘no conflict rule’ under UK common law, the two directives require fund managers to

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400. L.L.M. Wasima Khan, *Towards Context-Specific Directors’ Duties and Enforcement Mechanism in the Banking Sector?* 2 *Erasmus L. Rev.* 105 (2013).

401. As Member States adopt public EU Directive into public national law, investors will generally only be able to enforce a breach of contractual or civil law duties through lawsuits (and thus not public conduct of business duties).

402. Articles 14(1)(c) and (d) of the UCITS Directive and Article 12(1)(c) and (d) of the AIFM Directive.

403. See, e.g., R. Miller, *Fundamentals of Business Law: Summarized Cases* 402 (Cengage Learning 2012) (‘The agent’s actions must be strictly for the benefit of the principal and must not result in any secret profit for the agent’) and A.S. Gold & P.B. Miller (eds), *Philosophical Foundations of Fiduciary Law* 178 (Oxford University Press 2014) (‘A leading conception of fiduciary loyalty holds that loyalty requires the avoidance of conflicting interests’).

404. Articles 4(2) of Directive 2010/43/EU and 57(2) of the Commission Delegated Regulation on AIFMs.

405. It is the management company’s duty to ensure the confidentiality of information in order to prevent market abuse and insider dealing. See Article 6(3) MAD.

implement conflicts of interest policies containing the procedures for identifying, preventing and managing any conflicts of interest. They also require adequate and immediate disclosure of potential conflicts to investors. Since these rules have already been discussed in 3.4.2[A] and 3.6, I refer to these paragraphs.

In addition to the ‘no conflict rule’, UK fiduciary law also speaks of a so-called no profit rule.<sup>406</sup> The no profit rule sets out an obligation of the fiduciary to not profit from its fiduciary position. This includes any benefits or profits which, although unrelated to the fiduciary position, came about because of an opportunity that the fiduciary position afforded.<sup>407</sup> Since it would be impossible to maintain a fund management business without charging a fee that exceed the costs of the business, strict application of this rule is not found in (EU and US) laws applying to investment funds. However, if the manager makes a profit, by virtue of his role as manager for fund, or pays a fee to a third party service provider, he must disclose this profit to investors.<sup>408</sup>

### **[A] The Duty to Act in the Best Interest of Investors**

The duty of loyalty essentially requires that one person that owes this duty to another person treats that person fairly. In Article 22 of Directive 2010/43/EU this rule has been applied to UCITS management companies as it requires that they must refrain from placing the interests of any group of investors above the interests of any other group of investors. Article 12(1)(f) of the AIFM Directive even provides for a more explicit fairness rules for AIFMs by requiring AIFMs to ‘treat all AIF investors fairly’, although preferential treatment is allowed under certain circumstances. Preferential treatment of an AIF investor is permitted in case other investors are informed of that preferential treatment and it ‘does not result in an overall material disadvantage to other investors’.<sup>409</sup> Although the UCITS ‘fair treatment’ rules appears to be stricter than that applying to AIFMs, it still may have impacted the AIFM’s and AIF’s approach to side letters.<sup>410</sup> In addition, details of how the AIFM ensures the fair treatment of investors

406. See also Spangler, *Investment Management – Law and Practice*, 375 and Van Setten, *The Law of Institutional Investment Management*, 101.

407. The no profit rule is set out in *Regal (Hastings) Ltd v. Gulliver 2 A.C. 114G-145A* (1967): ‘The rule of equity which insists on those who by use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides; or upon questions or considerations as whether the property would or should otherwise have gone to the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of a profit having in the stated circumstances been made’.

408. Articles 29 Directive 2010/43/EU and 24 of the Commission Delegated Regulation on AIFMs. However, it can be noted that under Article 24(8) of MiFID 2, inducement paid to a third party investment firm providing portfolio management is prohibited, unless three conditions are satisfied: (1) clear, prior disclosure of the inducement has been made to the underlying client of the firm, (2) the inducement has been designed to enhance the quality of the service to the underlying client of the firm, and (3) the payment or non-monetary benefit does not impair compliance with the firm’s duty to act in the best interests of the underlying client.

409. Articles 12(1)(f) of the AIFM Directive and 23(2) of the Commission Delegated Regulation on AIFMs.

410. Side letters are separate agreements that supplement or modify the terms of the governing documents of a private fund. They are generally limited to the largest investors in the fund and

and of any preferential treatment will have to be covered in any information memorandum or offering document.

For both UCITS management companies and AIFMs, fair treatment does not necessarily mean equal treatment.<sup>411</sup> In the first place, fair treatment necessarily contains an element of subjectivity which takes account of the facts of a particular circumstance or case. Since there is no harmonizing definition of fair treatment, fund managers (and their competent authorities) will inevitably deal with fair treatment issues differently.<sup>412</sup> So may some Member States consider different treatment of investors to be 'fair' as long as it is properly disclosed prior to the investors, while others may require a more objective fairness standard.<sup>413</sup> The 'preferential treatment' option available to AIFMs even explicitly enables AIFMs to treat certain investors differently. For example, they may provide certain 'seed' investors with better terms, such as preferential fees, than those investing later in the AIF subject to disclosure of the different treatment.<sup>414</sup>

Second, there may be a difference in financial treatment among investors. For example, a fund manager that purchases shares at different prices could allocate to one fund account the more costly shares and to another account the less expensive ones or allocate shares on a first-come, first-serve basis.<sup>415</sup> However, if the fund clients have consented to the method of asset allocation used by the manager, it is in conformity with the allocation policy. If the allocation practice is furthermore unlikely to be 'overall to the disadvantage of any AIF, UCITS or a client whose order is to be aggregated', it is permissible under the duty of loyalty under the UCITS and AIFM Directive.<sup>416</sup>

UCITS management companies and AIFMs must also ensure that fair, correct and transparent pricing models and valuation systems are used for the UCITS/AIFs they manage and that they act in such a way as to prevent undue costs being charged to the funds and their investors.<sup>417</sup> With respect to UCITS, neither the UCITS Directive nor its implementing directives explain which costs are considered to be 'undue costs'. For

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consist preferential terms in return of a substantial amount of capital being invested, ranging from discounted fees to additional investment capacity. See J.M. Mannon & N.M. Blatherwick, *Private Fund Side Letters-Investor Agendas, Tactics and Disclosure*, 19 *Inv. Law* 3 (2012).

411. Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Advisers*, 14–34.

412. ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 51.

413. Zetsche, *The Alternative Investment Fund Manager Directive*, 188.

414. Seed (or initial) investors are investors that invest in a business at an early stage, to support the business until it can generate cash of its own. In its advice on implementing measures of the AIFM Directive, ESMA considered that it is not unfair to grant preferential treatment to seed investors as this 'generally has no overall material disadvantage to investors that join the fund later where seed investors take an additional investment risk in relation to the start up – unlike the following investors'. See ESMA, Consultation paper – ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/209, Jul. 2011, 53.

415. Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Advisers*, 14–31.

416. Articles 28(1)(a) of Directive 2010/43/EU and 29(1)(a) of the Commission Delegated Regulation on AIFMs.

417. Articles 22(3) and (4) of Directive 2010/43/EU and 67(1) and 17(2) of the Commission Delegated Regulation on AIFMs.

AIFMs, ESMA provides that excessive trading costs can be qualified as undue costs.<sup>418</sup> It is likely that such costs would also be considered unduly when charged by UCITS management companies.<sup>419</sup> Furthermore, it can be argued that certain soft dollar arrangements may result in undue costs for investors. In soft dollar arrangements, the manager's decision to direct trades to any particular broker for execution may be unduly influenced by a desire to reward that broker for the research it supplies. The lack of clear guidance as to how to interpret the 'undue costs' provision may have resulted in different interpretations among Member States as to regard to how to qualify such arrangement and thus whether or not they are in conflict with the duty of loyalty. In this context, it can also be referred to the obligation of both UCITS management companies and AIFMs to implement appropriate policies and procedures for preventing malpractices that might reasonably be expected to affect the stability and integrity of the market.<sup>420</sup> As with the undue cost provision, it is unclear what types of situations must be included in the policies adopted, other than those that might adversely affect the stability and integrity of the market, such as market timing and late trading practices.

As part of ensuring fair treatment for investors, UCITS management companies and AIFMs are required to act in the best interest of UCITS/AIF or, in the case of AIFMs, the AIF investors.<sup>421</sup> They should do so when: (1) directly executing dealing decisions on behalf of the UCITS or AIF, or (2) placing orders to deal on behalf of the UCITS or AIF with other entities for execution. The rationale behind this duty is the fact that '[c]ertain behaviour, such as market timing and late trading, may have detrimental effects on unit-holders and may undermine the functioning of the market'.<sup>422</sup> Consequently, UCITS management companies and AIFMs are required to, as mentioned above, put in place procedures to prevent malpractices and unreasonable charges and activities such as excessive trading, taking into account the investment objectives and policy of the UCITS or AIF they manage.<sup>423</sup>

The duty to act in the best interest of investors is derived from the 'best execution requirement' set out in the MiFID 2. MiFID 2 requires investment firms to take all reasonable steps to obtain the best possible result for the client taking into account price, costs, speed, likelihood of execution and settlement, size, nature, or any other consideration relevant to the execution of the order.<sup>424</sup> In Directive 2010/43/EU and the Commission Delegated Regulation on AIFMs, further details are provided regarding the best execution standard for UCITS management companies and AIFMs. Specifically,

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418. ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 41.

419. It is even likely that a greater degree of fairness is required for UCITS as they are generally targeted at retail investors which are deemed passive and unskilled in financial affairs. *See also* Zetsche, *The Alternative Investment Fund Manager Directive*, 188–189.

420. Articles 22(2) of Directive 2010/43/EU and 17(1) of the Commission Delegated Regulation on AIFMs.

421. Articles 14(1)(a) of Directive 2010/43/EU and 12(1)(b) of the Commission Delegated Regulation on AIFMs.

422. Recital 18 of Directive 2010/43/EU.

423. *Ibid* and recital 39 of the Commission Delegated Regulation on AIFMs.

424. Article 27(1) MiFID 2.

they require the implementation of an execution policy and ongoing monitoring of the effectiveness of their policy for the execution of orders in order to identify and, where appropriate, correct any deficiencies.<sup>425</sup>

In determining the relative weight of the best execution factors, the manager must determine the objectives, investment policy and risks specific to the UCITS or AIF, the characteristics of the order, the characteristics of the financial instruments that are the subject of that order, and the characteristics of the execution venues to which that order can be directed.<sup>426</sup> It follows from these rules that the best execution requirements are, in line with the MiFID 2 requirements, intended to be principle-based as they give fund manager considerable freedom as to how to comply with them. They focus on the implementation of execution policies that must include, in respect of each order, information on the different venues where the management company executes its orders and the factors affecting the choice of execution venue.<sup>427</sup> As a result, the best execution requirements do not require fund managers to determine whether they achieve with each order the best possible result for each individual investor or fund, but merely that the order is executed in accordance with the execution policy established by the manager.<sup>428</sup> However, this policy must reasonably be considered to be effective in order for it to meet the best interest standard set out in the UCITS and AIFM Directive. If, for example, conflicts arise in the context of the fee structure, as may for instance be the case in soft dollar arrangements, it might result in a burden of proof of the manager to demonstrate that the apparent conflict does not affect the effectiveness of the execution policy.<sup>429</sup> In addition, such conflicts must be disclosed to investors.<sup>430</sup>

### **[B] The Duty of Confidentiality**

As stated above, the best interest standard should be applied by UCITS management companies and AIFMs for each UCITS or AIF they manage. However, in case the manager manages multiple funds, it may result in confidentiality issues between those funds. Under Articles 4(2) of Directive 2010/43/EU and 57(2) of the Commission Delegated Regulation on AIFMs, UCITS management companies and AIFMs are required to ‘establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information’. When the manager uses electronic systems for data processing, it should, where appropriate, ensure a high level of security as

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425. Articles 25(2), (3) and (4) of Directive 2010/43/EU and 27(2), (3) and (4) of the Commission Delegated Regulation on AIFMs.

426. Articles 25(2) and 26(2) of Directive 2010/43/EU and 27(2) and 28(2) of the Commission Delegated Regulation on AIFMs.

427. Van Setten, *The Law of Institutional Investment Management*, 55.

428. *Ibid.*

429. *Ibid.*, 262.

430. *See* n. 142, *supra*.

regards the integrity and confidentiality of the recorded information.<sup>431</sup> In some cases, however, the duty of confidentiality may conflict with the duty to act in the best interest of the UCST. For example, a UCITS management company may place a large order to buy company stock on behalf of one UCITS, driving the last known price of those shares upwards, and use that information to place a second order to sell that stock after the first order is transmitted on behalf of another UCITS. This would benefit the second UCITS and harm the first UCITS as the sale would downward the stock price. Apart from potential insider dealing violations, application of the duty of confidentiality would result in an affirmative duty of the fund manager to not use the information about the first transaction for the purpose of the second transaction, while the best interest rule would require the fund manager to use the information to generate the best possible result for the second UCITS. However, the duty of loyalty, while on the one hand imposing a legal duty to act in the best interest of the UCITS, also imposes the negative obligation ‘to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers’.<sup>432</sup>

Because of this duty to refrain from doing anything that would injure the fund, it would be sensible to conclude that the management company should not sell the shares as this would harm the interest of one of the UCITS it manages, even though this would be in ‘the best interest’ of another UCITS. In addition, fund managers are required to comply with rules on order handling, which require, among other things that it may not ‘misuse information relating to pending UCITS or AIF orders’ and should carry out a UCITS or AIF order in aggregate with an order of another UCITS or AIF unless (1) it is unlikely that the order will work overall to the disadvantage of any UCITS or AIF and (2) the allocation policy provides for the fair allocation of aggregated orders, including how the volume and price of orders determines allocations and the treatment of partial executions.<sup>433</sup>

431. Articles 7(2) of Directive 2010/43/EU and 58(2) of the Commission Delegated Regulation on AIFMs.

432. C.W. Furlow, *Good Faith, Fiduciary Duties, and the Business Judgement Rule in Delaware*, 3 Utah L. Rev. 1068 & n. 7 (2009). See also L. Thévenoz & R. Bahar (eds), *Conflicts of Interest: Corporate Governance and Financial Markets* 344 & 345 (Kluwer Law International 2007) (stating that the duty of loyalty in the UCITS Directive imposes a duty on fund managers ‘to avoid conflicts of interest that may affect the interests of investors in their funds’ and ‘[i]f such conflicts cannot be avoided, [that] these interests must be “treated fairly”, i.e., must not be “prejudiced.”’) and Gold & Miller (eds), *Philosophical Foundations of Fiduciary Law*, 178 (‘This narrower conception of a fiduciary loyalty involves an anti-conflict obligation (a duty to avoid conflicts of interest), but without required a single undivided loyalty to one beneficiary’, as a result of which, ‘the fiduciary “must refrain from self-interested behavior that wrongs the fiduciary”’).

433. Articles 27(2) and 28 of Directive 2010/43/EU and 25(4) and 29 of the Commission Delegated Regulation on AIFMs.

### 3.8.2 The Duty of Care

A UCITS management companies' and AIFM's duty of care have been expressed in the UCITS Directive and the AIFM Directive as the duty to act with 'due skill, care and diligence'.<sup>434</sup> This requirement consist of two pillars: (1) the requirement to act with due skill and care and (2) due diligence requirements.

With respect to the duty to act with due skill and care, Article 7(1)(b) of the UCITS Directive sets out that persons who effectively conduct the business of the management company must be 'of sufficiently good repute' and be 'sufficiently experienced in relation to the type of UCITS managed'. Article 8(1)(c) of the AIFM Directive provides for a similar requirements for the directors of AIFMs. In general, the duty of care sets the standard for the exercise of the performance of the management duty, which is the standard of professional judgment, knowledge and skill required of the manager in making investment decisions.<sup>435</sup>

For AIFMs, additional conditions are provided related to when its governing personnel conducts their activities in accordance with the duty of care. Under Article 21 of the Commission Delegated Regulation on AIFMs, the governing body of the AIFM must possess adequate collective knowledge, skills and experience regarding the activities of the AIFM, in particular regarding the main risks of the AIFM and types of investments it invests in. Furthermore, the governing body must commit sufficient time to perform their functions and the AIFM must devote adequate resources to the induction and training of the body. Lastly, each member of the governing body must act with 'honesty, integrity, and independence of mind'.

For UCITS management company, such requirements currently do not exist, but it can be argued that similar conditions should apply.<sup>436</sup> In both cases, however, the AIFM or UCITS management company that files for authorization at his home Member State will generally be required to proof the skills of its staff members by supplying relevant information about their work experience and expertise to the competent authorities in the financial field in general and with respect to the activities of the UCITS management company or AIFM in particular. Since no additional guidance exists as to when a staff member of the governing body, for example, possesses 'sufficient skills' or conducts 'sufficient time' to perform his management task, it will depend on how the particular Member State has implemented this provision in its authorization form. Nevertheless, in any event, the manager will have to provide information about its governing member's education and practical experience in order to cover all theoretical and practical aspects in the field of its business.

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434. Articles 14(1)(b) of the UCITS Directive and 12(1)(a) of the AIFM Directive.

435. Van Setten, *The Law of Institutional Investment Management*, 84.

436. See also Setten & Busch, *Alternative Investment Funds in Europe – Law and Practices*, 45 (note 230). Article 5(4) of Directive 2010/43/EU only requires that the Member States ensures that the management company takes into account 'the nature, scale and complexity of the business of the management company, and the nature and range of series and activities undertaken in the course of that business' when employing personnel with sufficient skill, knowledge and experience.

With respect to the requirement of ‘being of good reputation’, it makes sense that the persons in question have no criminal records, including convictions of financial crimes such as money laundering and insider trading.<sup>437</sup> Furthermore, in order to prevent conflicts, at least two persons must decide on matters related to the conduct of the fund’s business and the existence of a ‘close link’ between the fund manager and persons is only allowed if this link does not prevent effective supervision.<sup>438</sup> In case a staff member of a UCITS management company performs multiple functions by relevant persons, the management company must ensure that the performance of those functions ‘does not and is not likely to prevent those relevant persons from discharging any particular function soundly, honestly, and professionally’.<sup>439</sup> There is no similar requirement in place for AIFMs.<sup>440</sup>

The duty to perform adequate due diligence for UCITS management companies has been specified in Article 23 of Directive 2010/43/EU. This article requires UCITS management companies to ensure a high level of diligence in the selection of and ongoing monitoring of investments. In addition, adequate knowledge and understanding of the assets in which the UCITS are invested are imposed as well as requirements to establish written policies and procedures on investment due diligence and on the risk management process.<sup>441</sup> In case the UCITS management companies has delegated its management powers to an external party, it will need to not only supervise this delegated manager, but also ensure that investment decisions on behalf of the UCITS are carried out in compliance with the objectives, investment strategy and risk limits of the UCITS. To this end, they should implement written policies and arrangements.<sup>442</sup> Furthermore, when a management company enters into a management arrangement with a third party in relation to the performance of risk management functions, it should ‘take the necessary steps in order to verify that the third party has the ability and capacity to perform the risk management activities reliably, professionally and effectively’.<sup>443</sup>

For AIFMs, similar rules apply, but the Commission Delegated Regulation on AIFMs sets out more detailed rules on the level of due diligence that has to be met by AIFMs that invest in assets with limited liquidity and have appointed certain third party service providers.<sup>444</sup> In case an AIFM invests in ‘assets with limited liquidity’, it must prepare a business plan for how these investments will be managed. This must be regularly updated by the AIFM. Transactions must be conducted in accordance with the business plan and due diligence must also be completed and documented on the

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437. ESMA, Final report – ESMA’s technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 127–128.

438. Articles 7(1)(b) and (2) of the UCITS Directive and 8(1)(c) and (3)(a) of the AIFM Directive.

439. Article 5(3) of Directive 2010/43/EU.

440. Although AIFMs are, similar to UCITS management companies, required to ensure that conflicts of interests arising from multiple functions are managed and disclosed appropriately. See section 3.4.1.

441. Article 23(2) and (4) of Directive 2010/43/EU.

442. Article 5(2) and 23(3) of Directive 2010/43/EU.

443. Article 23(4) of Directive 2010/43/EU.

444. See for the general obligation to apply a high standard of diligence in the selection and ongoing monitoring of investments Article 18 of the Commission Delegated Regulation on AIFMs.

assets in question.<sup>445</sup> Performance of the AIF must then be monitored on an ongoing basis by the AIFM.<sup>446</sup> The regulation does not define ‘limited liquidity’, but it can be assumed that this includes, in any case, private equity, infrastructure assets and real property.

With respect to third party service providers, AIFMs must ensure that their prime brokers and counterparties: (1) are subject to ongoing supervision by a public authority, (2) are ‘financially sound’ (taking into account whether the prime broker or counterparty is subject to prudential regulation, including minimum capital requirements), and (3) have the necessary organizational structure and resources for the provision of the envisaged services.<sup>447</sup> The effect of the above requirement is that AIFs managed by AIFMs are, since the adoption of the AIFM Directive, precluded from entering into OTC derivatives trades or securities lending transactions with unregulated entities. This also explains the link to these rules with the financial crisis of 2007, which exposed a number of deficiencies, including inadequacies in due diligence applied by AIFMs and other professionals on risky investments.

Despite of the above rules, it must be noted that the duty of care does not include the duty to achieve a profit on the investments made by the manager on behalf of the fund. It is an obligation to perform an *effort* (not a result) to invest the capital of the investors in the UCITS or AIF with a view to obtain a certain specified return.<sup>448</sup> In order to prevent potential liability claims, most investment management and subscription agreements therefore include a ‘no warranty’ clause which denies the fund and its investors to complain, on hindsight, that they have relied on certain assurance about the future return of the fund.

### 3.9 DEPOSITARY MONITORING RULES

As discussed in section 2.3.3[A], the UCITS and AIFM Directives require funds falling under the scope of these directives to appoint a separate, independent depositary. This depositary has, among other things, the duty to carry out a number of oversight tasks and to monitor the fund’s cash flows. In addition, the rules ensure that the depositary can be held liable in case of loss of assets held in custody as a result of a failure of the depositary to properly perform its duties under the UCITS or AIFM Directive.<sup>449</sup>

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445. Article 19(1) of the Commission Delegated Regulation on AIFMs.

446. Article 19(2) of the Commission Delegated Regulation on AIFMs. AIFMs shall retain records of the activities carried out pursuant to Article 19(1) of the Commission Delegated Regulation on AIFMs for at least five years.

447. Article 20(2) of the Commission Delegated Regulation on AIFMs.

448. Van Setten, *The Law of Institutional Investment Management*, 76–77.

449. Articles 24(1) of the UCITS Directive and 21(12) of the AIFM Directive (requiring the depositary to be liable for any losses of financial instruments held in custody suffered by the UCITS/AIF or its investors, unless the depositary ‘can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary’ and ‘for all other losses suffered by [the UCITS/AIF or its investors] as a result of the depositary’s negligent or intentional failure to properly fulfil its obligation’).

In general, the depositary has five key oversight duties: (1) reconciliation of subscription/redemption orders with the subscription proceeds/redemptions paid, and of the number of shares issued/cancelled with the subscription proceeds received/redemptions paid by the UCITS/AIF, (2) valuation of shares, (3) verification of compliance of UCITS/AIF with national law or its instruments of incorporation, as well as with investment restrictions and leverage limits defined in offering documents, (4) ensure timely settlement of transactions, and (5) correct income calculation with respect to UCITS/AIF instruments and applicable law, liaising eventually with auditors and verifying accuracy of dividend payments.<sup>450</sup>

These duties focus on ensuring that the fund manager complies with the applicable legal provisions and investment policies of the fund and are performed on an ex-post basis. This means that in order to comply with its oversight duties, the depositary is expected to perform ex-post controls and verifications of processes and procedures that are under the responsibility of the UCITS management company/AIFM, the UCITS/AIF or an appointed third party. The depositary should in all circumstances ensure a procedure exists, is appropriate, is implemented and frequently reviewed. It follows from these rules that depositaries should only simply check the procedures and verify that the manager complies with its own rules.<sup>451</sup> The Commission has acknowledged with respect to AIFs that, while the processes and procedures for exercising the oversight function should be proportionate to the estimated risks of the relevant AIF and without prejudice to the depositary's ability to conduct appropriate ex-ante verifications, in principle most verification checks will be ex-post second level controls.<sup>452</sup> They thus only provide for a limited protection for investors.

The requirement to monitor the fund's cash flows can be qualified, as an ex-ante duty. The depositary will have to ensure that all cash of a fund from whatever source, is booked into an account at a central bank, an EU authorized bank or a non-EU authorized bank as well as develop procedures to reconcile cash flows daily and check the consistency of its own records against those of the fund manager.<sup>453</sup> This means that the depositary will need to monitor every instruction relating to every cash account maintained by the fund to ensure that the transactions match the cash accounts of the fund and that there is no fraud. In addition, significant cash flows, in particular in case they can be identified as being inconsistent with the fund's operations, such as (large) changes in positions in the fund's assets or subscriptions and redemptions, should be

450. Articles 22(3) of the UCITS Directive and 21(9) of the AIFM Directive.

451. See Articles 93, 94, 96 and 97 of the Commission Delegated Regulation on AIFMs. For UCITS, the implementing measures providing guidance as to the duties of depositaries under the UCITS Directive will be adopted by the end of 2015. Since the UCITS depositary rules have been drafted on the model of the AIFM Directive, it can be assumed that the implementing measures will provide investors with at least the same level of protection. See also Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed UCITS V Directive, 7 (noting that '[t]he precedent set by the AIFMD constitutes nevertheless an essential point of reference for the improvement of the current depositary rules for UCITS').

452. Recital 109 of the Commission Delegated Regulation on AIFMs.

453. Articles 22(5) of the UCITS Directive, 21(7) of the AIFM Directive and 86 of the Commission Delegated Regulation on AIFMs.

raised with the fund or fund manager and potentially competent regulators if the depositary is not satisfied that such movements are legitimate.<sup>454</sup> This duty thus seeks to prevent fraud, book-keeping errors, and (the concealment of) self-dealing transactions by the fund manager.

It can be noted that the duty of cash monitoring does not protect investors against risks of losses as a result of other high risk-taking behaviour of the manager, false or incomplete disclosure, and other bad business practices, such as excessive fees and (self-dealing) transactions between the fund and affiliates that do not constitute an 'inconsistency with the fund's operations'.<sup>455</sup> In addition, an AIF depositary may discharge of its liability which may result in a lower incentive to adequately fulfil its monitoring tasks and responsibilities. The depositary can do so by written contract with the AIF or the AIFM acting on behalf of the AIF (thus not the investors), expressly allowing the discharge and stating the objective reason to contract such a discharge. Such an 'objective reason' must be established each time the depositary intends to discharge itself of liability, and must be limited to precise and concrete circumstances characterizing a given activity and be consistent with the depositary's policies and decisions.<sup>456</sup> A depositary can be exempted from this liability only if an event (resulting in a loss) is 'external', 'beyond reasonable control' and the consequences would have been 'unavoidable'.<sup>457</sup> These criteria make it challenging for a depositary to discharge its liability, as the depositary will, for example, remain liable for the actions of both affiliated and non-affiliated sub-custodians. The depositary will also retain liability for instances of fraud or insolvency within the subcustody network since accounting errors, operational failures and failure to apply the asset-segregation requirements properly at sub-custodian level also constitute 'internal events' for which the depositary is liable.

### 3.10 CONCLUSION

In this chapter, a number of EU investor protection rules applying to (the managers of) UCITS and AIFs have been discussed in order to give an answer to the second research question regarding the way in which funds are regulated under EU law with respect to the protection of investors. After having discussed some general aspects of UCITS and

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454. Article 86(e) and recital 98 of the Commission Delegated Regulation on AIFMs.

455. Such as transactions with affiliated parties that are not deemed significant and/or inconsistent with the fund's operation, such as the purchase of stock from an affiliated party by an equity fund.

456. Articles 21(13) of the AIFM Directive and 102(1) and (2) of the Commission Delegated Regulation on AIFMs. In situations where the depositary has no other option but to delegate its custody duties to a sub-custodian, the depositary will be deemed to have objective reasons for contracting the discharge of its liability. See Article 102(3) of the Commission Delegated Regulation on AIFMs.

457. Articles 21(12) of the AIFM Directive and 101 of the Commission Delegated Regulation on AIFMs. According to the Commission Delegated Regulation on AIFMs, an event is beyond the reasonable control of a depositary in case 'there was nothing a prudent depositary could reasonably have done to prevent the occurrence of the event'. This includes, among other things, natural events and acts of a public authority. See recital 118 to the Commission Delegated Regulation on AIFMs.

AIFs, the chapter continued with an analysis of the different categories of EU rules that were determined in Chapter 2 as being most relevant to this research. These six categories include: (1) internal control systems, (2) leverage restrictions, (3) rules related to investor meetings, (4) transparency and disclosure rules, (5) conduct of business rules, and (6) depositary monitoring duties.

Both UCITS management companies and AIFMs are required to implement various internal control systems designed to secure compliance with the applicable rules and regulations, mitigate risks, and, most notably, protect investors. The internal control rules for UCITS management companies and AIFMs have a principle-based approach as they do not specify the exact policies that must be implemented. However, the applicable regulation contains a number of rule-based requirements specifying the specific types of policies that should be implemented (i.e., conflicts of interest, risk management, liquidity, valuation, and remuneration policies). In addition, there are some detailed rules on, most notably, the risk measurement methods that must be used by UCITS, and the supervisory function, including non-executive members, that must be implemented at AIFMs to determine and oversee the manager's remuneration. With respect to the remuneration of the fund manager, it can also be noted that recent rules for UCITS and the AIFM rules and regulations have placed some restrictions on the use of variable remuneration, including carried interest, although they are still allowed under both frameworks.

The use of leverage has been restricted for UCITS. UCITS may borrow up to 10% of their NAV on a temporary basis. While this suggested that any significant kind of long-term leverage would therefore be ineligible, their ability to invest in derivatives necessarily allows synthetic leverage. However, the restrictions on the global exposure of a UCITS fund to derivatives has been limited to the NAV of the fund. AIFMs are allowed to use unrestricted leverage, but should disclose their leverage exposure to investors on an ongoing basis.

With respect to investors' right to vote at investor meetings of funds, it can be concluded that EU law enables fund managers and boards to impose a number of restrictions on the exercise of this right. They include, among others: limits on investors' ability to submit agenda items or proposals, short notice periods, share blocking practices, admission fees to attend meetings charged by intermediaries, and the availability of information when shares are held via an intermediary. Some practical restrictions relating to the ability of investors to attend investor meetings can be solved if investors are able to vote electronically via electronic proxy voting, electronic direct voting, or virtual shareholder meetings. Although EU law gives Member States significant freedom to allow these forms of voting or to adopt virtual meeting legislation, only Denmark has adopted such a law thus far.

The UCITS and AIFM Directive both provide for an extensive framework of transparency and disclosure requirements. Investors in UCITS are provided with a prospectus and KII containing relevant, accessible and short (understandable) information about the fund. While the KII can be seen as an improvement of the former simplified prospectus document, some improvements may still be necessary with respect to the presentation of the management fees, the SSRI indicator (currently perceived by market participants to be too prominent), and the information on the

investment strategies and objective of the fund included in the KII. AIFMs are subject to extensive pre-contractual information duties as well. The information that must be provided is very similar to the information included in the KII of UCITS, although they are much less detailed than the UCITS prospectus. In addition, the disclosure is form-free, but Member States may impose certain requirements on AIFMs regarding to the format and layout of the AIF prospectus. This may however result in difference between Member States as regards essential elements of the prospectus document, such as cost disclosure. The ongoing disclosure of UCITS is limited to the publication of an annual and half-yearly report and periodic NAV disclosures. AIFMs on the other hand are subject to more detailed ongoing disclosures regarding their liquidity, risk and leverage exposure and conflict of interests, in addition to periodic NAV disclosures. They should also publish an annual report, the latest version of which must also be provided to investors prior to the investments.

It follows from the assessment of the conduct of business rules that UCITS management companies and AIFMs are subject to the duty of loyalty and care under EU (securities) law. As part of duty of loyalty, they must act in the best interest of the UCITS/AIF or AIF investors when executing dealing decisions or placing orders to deal on behalf of the fund and refrain from doing anything that would harm the fund. The rules related to these aspects are principle-based in nature and focus on the implementation of an execution and allocation policy and ongoing monitoring of the effectiveness of these policies. The duty of care consists of a requirement relating to the skills and experience of staff members and due diligence requirements in the selection of and ongoing monitoring of investments, including the implementation of due diligence policies and, for AIFMs, the selection of third party service providers.

Lastly, the EU depositary monitoring rules requires the depositary of a UCITS or AIF to perform ex-post controls and verifications of processes and procedures that are under the responsibility of the UCITS, AIF, or an appointed third party. Due to this ex-post nature, the relevance of these oversight duties for investors may be low as inefficiencies may be detected by the depositary too late, i.e., after the fund has become insolvent. In addition, it should perform the ex-ante duty to ensure that proper procedures to reconcile all cash flow movements and identify potential ones inconsistent with the fund's operations, reporting anomalies to manager without undue delay, and a reconciliation process to be reviewed at least once a year to check consistency of depositary's records with those of the UCITS management company or AIFM. Although the monitoring of the fund's cash flows does not protect investors against risks of losses as a result of other high risk-taking behaviour of the manager, false or incomplete disclosure, and other bad business practices, such as excessive fees, it does minimize the risk of loss or diminution of the cash assets because of the (timely) detection of fraud, deficient administration/management, inadequate records or negligence.