

AIFM DIRECTIVE

Briefing

AIFM Remuneration Rules

May 2013

Summary

The Alternative Investment Fund Managers Directive (“[AIFM Directive](#)”) was agreed in November 2010, came into force in the European Union (“EU”) on 21 July 2011 and must be implemented into the national law of all EU countries by 22 July 2013. The AIFM Directive sets forth rules for the authorisation, operation and transparency (i.e., disclosure requirements) and remuneration of managers of alternative investment funds (“AIFs”).

This *Briefing* covers the specific remuneration requirements that the AIFM Directive imposes on EU-authorized alternative investment fund managers (“AIFMs”) (being EU AIFMs and those non-EU AIFMs that opt (after 2015) to become authorised in the EU) as well as the more granular, detailed requirements under those AIFM Directive requirements set forth in the remuneration guidelines published by the European Securities and Markets Authority (“ESMA”) on 11 Feb. 2013 (the “ESMA Guidelines”).¹

Introduction

The AIFM Directive is merely a framework and requires that the European Commission (the “Commission”) should prepare detailed rules on a large number of the topics covered by the AIFM Directive in the form of subordinate legislation. Many of the detailed rules, which expand upon the principles set forth in the AIFM Directive’s initial framework, were adopted by the Commission on 19 Dec. 2012 in the form of a delegated regulation (the “Delegated Regulation”),² although the remuneration rules were delegated from the Commission to ESMA, which published Guidelines for AIFMs and EU regulators on 11 Feb. 2013.

The AIFM Directive states that in order to address the potentially detrimental effect of poorly designed remuneration structures on the sound management of risk and control of risk-taking behaviour by individuals, there should be an express obligation for AIFMs to establish and maintain for those categories of staff whose professional activities have a material impact on the risk profiles of AIFs they manage (“Identified Staff”), remuneration policies and practices that are consistent with sound and effective risk management.

The AIFM Directive imposes restrictions on the amount and form of remuneration that an AIFM may pay to Identified Staff and requires that AIFMs must put in place remuneration policies and practices for Identified Staff, designed to promote sound and effective risk management and not to encourage risk taking which is

¹ See <http://www.esma.europa.eu/system/files/2013-201.pdf>.

² See http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf. In implementing the detailed rules in the form of an EU regulation, the Commission has ensured that every country of the EU will have the same requirements for the management and marketing of AIFs as an EU regulation, once it comes into effect, is the *de facto* law of every country of the EU — without needing to be implemented or adopted into national law.

inconsistent with the risk profiles and rules of the AIFs that the AIFM manages. Annex II of the AIFM Directive sets forth a range of principles derived from and similar to those set forth in the EU Capital Requirements Directive (“CRD”),³ which many EU AIFMs will already be familiar with and subject to in their capacity as EU-based investment firms.⁴ However, several types of EU AIFMs⁵ and non-EU AIFMs that are caught under the AIFM Directive’s remuneration rules will be facing these remuneration rules for the first time and will need to assess whether the AIFM Directive requirements that they align risk with pay will require any changes to the AIFM’s pay arrangements.

Application to AIFMs

The AIFM Directive does not specify which types of AIFMs that its remuneration rules apply to and it simply makes reference to “AIFMs” more broadly.⁶

Subject to national law or regulation applying the AIFM remuneration rules to non-EU AIFMs, the two elements of the AIFM Directive remuneration rules that non-EU AIFMs would be required to comply with where they were marketing an AIF in the EU are the disclosure obligations in the AIF’s annual report relating to:

- (1) The total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, and number of beneficiaries, and, where relevant, carried interest paid by the AIF — which must be disclosed by all AIFMs (whether based in the EU or not); and
- (2) The aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

Identified Staff

An AIFM’s remuneration policies and practices must cover all Identified Staff. The ESMA Guidelines define Identified Staff as “*categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the AIFM’s risk profile or the risk profiles of the AIF that it manages and categories of staff of the entity(ies) to which portfolio management or risk management activities have been delegated by the AIFM, whose professional activities have a material impact on the risk profiles of the AIF that the AIFM manages.*”

³ 2006/48/EC and 2006/49/EC

⁴ UK-based investment firms that are defined as BIPRU firms (subject to the FSA Prudential sourcebook for Banks, Building Societies and Investment Firms, which will include most hedge/private fund and debt fund managers) have been subject to a similar set of remuneration requirements from 1 Jan. 2011 (set forth in Chapter 19A of the FSA’s Systems and Controls Sourcebook (<http://fsahandbook.info/FSA/html/handbook/SYSC/19A>)).

⁵ In particular, many private equity fund managers and real estate fund managers.

⁶ However, the ESMA Guidelines clarify that the remuneration rules are only applicable to EU AIFMs and EU regulators. The ESMA Guidelines note that as long as EU countries maintain national private placement rules for the purposes of non-EU AIFMs marketing AIFs in the applicable EU country, then the remuneration rules will not be applicable to non-EU AIFMs. However, because EU countries have discretion as to how to implement the ESMA Guidelines into national rules, there is scope for one or more EU countries to apply the AIFM remuneration requirements in the ESMA Guidelines to all AIFMs operating in such country or countries. Where an EU country withdraws or ceases to have private placement rules for marketing interests in AIFs, the ESMA Guidelines recommend that the remuneration requirements should be extended to all AIFMs operating in that country.

The ESMA Guidelines further define, for these purposes:

- (1) “Control functions” as “staff (other than senior management) responsible for risk management, compliance, internal audit and similar functions within an AIFM (e.g., the CFO to the extent that he/she is responsible for the preparation of the financial statements)”; and
- (2) “Risk takers” as “staff members, whose professional activities — either individually or collectively, as members of a group (e.g., a unit or part of a department) — can exert material influence on the AIFM’s risk profile or on an AIF it manages, 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 staff can include, for instance, sales persons, individual traders and specific trading desks.”

The ESMA Guidelines note that administrative or logistical support staff should not be considered risk takers as they do not have any connection with the risk profile of the AIFM or the AIF and so will not be included within the definition of Identified Staff. However, the exclusion only applies to support staff whereas those senior managers who manage the AIFM’s administration team should be included as Identified Staff.

Remuneration

The AIFM Directive does not specifically define “remuneration,” but it does make reference to fixed and variable remuneration that may be paid by an AIFM to its staff, as well as distinguishing such fixed and variable remuneration for staff from any carried interest paid by the AIF to the AIFM.⁷ However, Annex II of the AIFM Directive specifies that the remuneration rules shall apply to remuneration of any type paid by the AIFM, to any amount paid directly by the AIF itself, including carried interest, and to any transfer of units or shares of the AIF, made to the benefit of Identified Staff.

It further adds that all remuneration can be divided into either fixed remuneration (payments or benefits without consideration of any performance criteria) or variable remuneration (additional payments or benefits depending on performance or, in certain cases, other contractual criteria). Both components of remuneration (fixed and variable) may include monetary payments or benefits (such as cash, shares, options, cancellation of loans to staff members at dismissal, pension contributions, remuneration by AIFs (e.g., through carried interest models) or non- (directly) monetary benefits (such as discounts, fringe benefits or special allowances for car, mobile/cell phone etc.)). The ESMA Guidelines adds that ancillary payments or benefits that are part of a general, non-discretionary, AIFM-wide policy and pose no incentive effects in terms of risk assumption can be excluded from the definition of “remuneration” for the purposes of the AIFMD-specific risk alignment remuneration requirements.

It is worth noting that the AIFM Directive and the ESMA Guidelines pay particular attention to the concept of “carried interest” — which the AIFM Directive defines as “a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF and excluding any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF.” ESMA considers that any payment made directly by the AIF to the benefit of the Identified Staff which consists of a pro rata return on any investment made by Identified Staff into the AIF does not represent remuneration within the meaning of the AIFMD and, therefore, is not subject to any of the remuneration requirements set out in the AIFM Directive and the detailed guidelines set forth in the ESMA Guidelines. ESMA notes that a key purpose of the remuneration requirements is to align the interests of the Identified Staff with those of the AIFM and the AIFs it manages and that, in this case, the alignment of the interests of the Identified Staff with those of the AIFM and the AIFs it manages is facilitated by the fact that the Identified Staff invest into the AIFs and, therefore, no additional safeguards would be necessary to ensure the alignment of interests. However, ESMA considers that in order for a return on an investment made by Identified Staff into the AIF to be considered exempt from the remuneration provisions, the investment needs to consist in an actual disbursement made by the Identified Staff (i.e., loans granted by the AIFM to the Identified Staff in order to allow a co-investment into the AIF should not be considered as an investment for the purposes of the exemption if the loan has not been reimbursed by the Identified Staff by the time the return is paid).

⁷ For more information on the content requirements of an AIF’s annual report, see [SRZ Briefing, Disclosure and Reporting Rules](#).

AIFM Directive Remuneration Rules

The AIFM Directive requires that an AIFM must comply with a number of principles (set forth in Annex II to the AIFM Directive) when establishing and applying its remuneration policies and practices (inclusive of salaries and discretionary pension benefits) for Identified Staff. The core requirement is that the AIFM must have a remuneration policy that is consistent with and promotes sound and effective risk management and it must not encourage risk-taking that is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs that they manage. The AIFM's remuneration policy must include conflicts avoidance measures and must be in line with the business strategy, objectives, values and interests of the AIFM and the AIFs it manages or the investors in such AIFs. The policy and its implementation must be periodically reviewed. Additional requirements in Annex II to the AIFM Directive include:

- (1) The implementation of the remuneration policy must be, at least annually, subject to central and independent internal review by the AIFM for compliance with policies and procedures for remuneration adopted by AIFM's management body in its supervisory function;
- (2) Identified Staff engaged in control functions must be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;
- (3) The remuneration of the senior officers in the risk management and compliance functions must be directly overseen by the AIFM's remuneration committee;
- (4) Where remuneration is performance related, the total amount of remuneration must be based on a combination of the assessment of the performance of the individual and of the business unit or AIF concerned and of the overall results of the AIFM, and when assessing individual performance, financial as well as non-financial criteria are taken into account;
- (5) The assessment of performance must be set in a multi-year framework appropriate to the life-cycle of the AIFs managed by the AIFM in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the redemption policy of the AIFs it manages and their investment risks;
- (6) Guaranteed variable remuneration must be exceptional, should occur only in the context of hiring new staff and must be limited to the first year of employment of any Identified Staff;
- (7) Fixed and variable components of total remuneration must be appropriately balanced and the fixed component should represent a sufficiently high proportion of the person's total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component;
- (8) Payments related to the early termination of a contract must reflect performance achieved over time and are designed in a way that does not reward failure;
- (9) The measurement of performance used to calculate variable remuneration components or pools of variable remuneration components must include a comprehensive adjustment mechanism to integrate all relevant types of current and future risks;
- (10) Subject to the legal structure of the AIF and its rules or instruments of incorporation, a substantial portion, and in any event at least 50 percent of any variable remuneration must consist of units or shares of the AIF concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments, unless the management of AIFs accounts for less than 50 percent of the total portfolio managed by the AIFM, in which case the minimum of 50 percent shall not apply. (The instruments used to pay such variable remuneration must be subject to an appropriate retention policy designed to align incentives with the interests of the AIFM and the AIFs it manages and the investors of such AIFs.);
- (11) A substantial portion, and, in any event, at least 40 percent, of the variable remuneration component, must be deferred over a period which is appropriate in view of the life cycle and redemption policy of the AIF concerned and must be correctly aligned with the nature of the risks of the AIF in question. (The period must be at least three to five years unless the life cycle of the AIF concerned is shorter; remuneration payable under deferral arrangements must vest no faster than on a pro rata basis; in

the case of a variable remuneration component of a particularly high amount, at least 60 percent of the amount must be deferred);

- (12) The variable remuneration, including the deferred portion, must be paid or vest only if it is sustainable according to the financial situation of the AIFM as a whole, and must be justified according to the performance of the business unit, the AIF and the individual concerned. (The total variable remuneration must generally be considerably contracted where subdued or negative financial performance of the AIFM or of the AIF concerned occurs, taking into account both current compensation and reductions in pay-outs of amounts previously earned, including through malus⁸ or clawback arrangements⁹);
- (13) The AIFM's pension policy (if any), must be in line with the business strategy, objectives, values and long-term interests of the AIFM and the AIFs it manages. (If an employee leaves the AIFM before retirement, discretionary pension benefits must be held by the AIFM for a period of five years in the form of units or shares of the AIF concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments. In the case of an employee reaching retirement, discretionary pension benefits must be paid to the employee in the form of units or shares of the AIF concerned, or equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments, subject to a five-year retention period);
- (14) Staff must be required to undertake not to use personal hedging strategies on remuneration — and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;¹⁰
- (15) Variable remuneration must not be paid through vehicles or methods that facilitate the avoidance of the remuneration rules set forth in the AIFM Directive. The ESMA Guidelines expands upon this requirement and adds that the governing body of each AIFM has the primary responsibility for ensuring that the ultimate goal of having sound and prudent remuneration policies and structures is not improperly circumvented. Circumstances and situations that may pose a greater risk from this perspective may be:
 - (a) The conversion of parts of the variable remuneration into benefits that normally pose no incentive effect in respect of risk positions;
 - (b) The use of tied agents or other persons not considered “employees” from a legal point of view;
 - (c) Transactions between the AIFMs and third parties in which the risk takers have material interests; and
 - (d) The setting up of structures or methods through which remuneration is paid in the form of dividends or similar pay outs (e.g., improper use of performance fees) and non-monetary material benefits awarded as incentive mechanisms linked to the performance.

⁸ “Malus,” which means “bad” in Latin, in this context means that Identified Staff whose activities cause the AIF to lose money are penalised — meaning they won't get all of the withheld part of their bonus if they cause the AIF to lose money in subsequent years. Malus arrangements require that poor performance by Identified Staff lead to a reduction being made to a deferred award prior to vesting (i.e., before ownership has transferred to the Identified Staff). A “malus arrangement” is defined in the ESMA Guidelines as an “*arrangement that permits the AIFM to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performances of the AIFM as a whole, the business unit, the AIF and, where possible, the staff member. Malus is a form of ex-post risk adjustment.*”

⁹ In the UK, the FSA distinguishes between adjustments made to deferred variable remuneration (i.e., bonus payments) that has not yet vested (known as “malus”) and that which has already vested but which the individual agrees to repay (known as “clawback”). A “clawback arrangement” is defined in the ESMA Guidelines as a “*contractual agreement in which the staff member agrees to return ownership of an amount of remuneration to the AIFM under certain circumstances. This can be applied to both upfront and deferred variable remuneration. When related to risk outcomes, clawback is a form of ex-post risk adjustment.*”

¹⁰ The ESMA Guidelines note that staff may be considered to have hedged away the risk of a downward adjustment in remuneration if the staff member enters into a contract with a third party which requires the third party to make payments directly or indirectly to the staff member that are linked to or commensurate with the amounts by which the staff member's variable remuneration has been reduced. The contract could for instance take the form of an option or any other derivative contract or other form of contract which provides any type of hedging for the staff member's variable remuneration.

While many of these requirements are specifically expressed to apply with regard to the remuneration of Identified Staff, the ESMA Guidelines note that the risk alignment provisions should ideally be applied on an AIFM-wide basis.

Proportionality

AIFMs are permitted by the AIFM Directive to take a proportionate approach to the remuneration principles set forth in Annex II of the AIFM Directive by complying with the principles in a way and to the extent that is appropriate to the AIFM's size, internal organisation and the nature, scope and complexity of its activities.

The ESMA Guidelines clarify that the proportionality principle applies to the general as well as to the specific remuneration requirements of the AIFM Directive. The effect of the proportionality principle is that not all AIFMs will have to give substance to the remuneration requirements in exactly the same way and to the same extent. Proportionality operates both ways: some AIFMs will need to apply more sophisticated policies or practices in fulfilling the requirements; other AIFMs can meet the requirements of the AIFM Directive in a simpler or less burdensome way. As a result, the proportionality principle may lead to a tailored application of some requirements if this is reconcilable with the risk profile, risk appetite and the strategy of the AIFM and the AIFs it manages.

If an AIFM chooses to apply the AIFM Directive remuneration requirements in a tailored way, it must be able to justify to its EU regulator why it considers it to be appropriate for the firm or for its Identified Staff — and it should be able to explain the rationale for every single requirement that is applied in a tailored manner.

Neutralization: The ESMA Guidelines recognise that there is a very wide variety in size, internal organization and the nature, scope and complexity of the activities of different AIFMs, and consequently include express recognition that the application of the proportionality principle may lead to “neutralization” of some of the remuneration requirements — but only where it is reconcilable with the risk profile, risk appetite and strategy of the relevant AIFM and of the AIF(s) it manages.

As a result of the proportionality principle and the recognition that some of the ESMA Guidelines may not be appropriate for every AIFM, it *may* be possible for AIFMs to comply with the remuneration requirements recommended by ESMA in a tailored manner, depending on the size and complexity of their business etc. — although this will also depend on how EU national regulators implement the ESMA Guidelines into national regulations in different EU countries. (See Implications and National Implementation below.)

Remuneration Committee

Subject to national remuneration rules implementing the ESMA Guidelines, AIFMs that are significant in terms of their size or the size of the AIFs they manage, their internal organisation and the nature, the scope and the complexity of their activities are required by the AIFM Directive to establish a remuneration committee. The remuneration committee must be constituted in a way that enables it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk.

Where such a large or significant AIFM is required to have a remuneration committee, the AIFM Directive states that the remuneration committee must take responsibility for decisions regarding remuneration, including those which have implications for the risk and risk management of the AIFM or the AIF concerned and which are to be taken by the management body in its supervisory function. The members of the remuneration committee, including its chairman, must be members of the AIFM's management body who do not perform any executive functions for the relevant AIFM.¹¹

The ESMA Guidelines note that when assessing whether or not an AIFM is significant — and, therefore, whether it should have a remuneration committee — consideration should be given to the cumulative presence of the three factors: (1) its size or the size of the AIFs it manages, (2) its internal organization, and (3) the nature, scope and complexity of its activities. An AIFM which is significant only with respect to one or two of the three above factors would not be required to set up a remuneration committee. The ESMA

¹¹ In a small AIFM this requirement could be a significant restriction on the founder(s) being able to control compensation for the AIFM's staff, but because the AIFM Directive remuneration rules are subject to national implementation, proportionality requirements and because only “significant” AIFMs have to have a remuneration committee, this requirement should not apply to most small AIFMs.

Guidelines further note that some specific (but non-exhaustive) elements that AIFMs should take into account when determining whether or not to establish a remuneration committee are:

- (1) Whether the AIFM is listed or not;
- (2) The legal structure of the AIFM;
- (3) The number of employees of the AIFM;
- (4) The AIFM's assets under management;
- (5) Whether the AIFM is also a UCITS management company; and
- (6) Whether the AIFM is also authorised by its EU regulator to conduct other activities other than managing AIFs.

The following examples are set forth in the ESMA Guidelines as types of AIFMs that would not need to establish a remuneration committee:

- (1) AIFMs for which the value of the portfolios of AIFs that they manage does not exceed EUR 1.25 billion (or equivalent) and not having more than 50 employees, including those dedicated to the management of UCITS and the provision of additional (i.e., non-AIFM Directive) services; and
- (2) AIFMs which are part of banking, insurance, investment groups or financial conglomerates within which an entity is obliged to set up a remuneration committee which performs its tasks and duties for the whole group, provided that the rules governing such remuneration committee's composition, role and competences are equivalent to the ones set out in these guidelines and the existing remuneration committee takes responsibility for checking the compliance of the AIFM with the rules set out in these guidelines.

However, notwithstanding the foregoing, any AIFMs that fall within the examples set forth above may still opt to establish a remuneration committee at their own initiative as a matter of good practice.

Delegation Issues

The ESMA Guidelines specify that when delegating portfolio management or risk management activities to a third party (with such delegation conducted in accordance with the requirements of the AIFM Directive), an AIFM should ensure that:

- (1) The entities to which portfolio management or risk management activities have been delegated are subject to regulatory requirements on remuneration that are equally as effective as those applicable under the ESMA Guidelines; or
- (2) Appropriate contractual arrangements are put in place with entities to which portfolio management or risk management activities have been delegated in order to ensure that there is no circumvention of the remuneration rules set out in the ESMA Guidelines; these contractual arrangements should cover any payments made to the delegates' identified staff as compensation for the performance of portfolio or risk management activities on behalf of the AIFM.

The implications of these guidelines would appear to be that an EU AIFM may only delegate portfolio management or risk management activities to a delegate that is either (1) located in the EU (and which would, therefore, be subject to remuneration rules equivalent to the provisions of the ESMA Guidelines — such as a firm authorised/licensed in the EU under MiFID¹²), or (2) contractually required to comply with equivalent provisions. However, until EU national regulators implement national legislation implementing the ESMA Guidelines into domestic law in each EU country (see Implications and National Implementation below), it will be difficult to specify exactly what contractual requirements would have to be drafted into any new delegation arrangements.

¹² The EU markets in Financial Instruments Directive of 2004.

Disclosure Requirements

An EU AIFM must disclose details of its remuneration policies and practices to its regulator — as will any non-EU AIFM that wishes (after late 2015) to take advantage of the EU marketing passport and which registers with the regulator in its Member State of Reference.¹³ The AIF's annual report (which must be made available to EU investors) must also contain disclosure of the total remuneration for the financial year, split into:

- (1) Fixed and variable remuneration paid by the AIFM;
- (2) The number of beneficiaries and details of carried interest paid; and
- (3) The aggregate amount of remuneration paid to Identified Staff.¹⁴

Implications and National Implementation

The ESMA Guidelines themselves are technically not legally binding on AIFMs or on EU national regulators — although EU national regulators are obliged by the EU legislation that established ESMA to make every effort to comply.¹⁵ Notwithstanding the foregoing, it is generally anticipated that EU national regulators will prepare national legislation implementing the ESMA Guidelines into domestic law in each EU country. Given the ESMA Guidelines' proportionality principle and the scope for EU national regulators to be flexible in their approach to the remuneration principles set forth in the ESMA guidelines, a great deal of work still needs to be undertaken before AIFMs will be able to clearly understand the consequences of the AIFM Directive remuneration requirements on their remuneration practices and on their carried interest and co-investment arrangements.

For more information on the issues set forth in this *Briefing*, please contact your attorney at Schulte Roth & Zabel or one of the following attorneys: [Christopher Hilditch](#) and [Steven Whittaker](#).

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¹³ For more information on the marketing passport and the ability for non-EU AIFMs to become registered in the EU, see [SRZ Briefing, Marketing Requirements](#).

¹⁴ For more information on the content requirements of an AIF's annual report, see [SRZ Briefing, Disclosure and Reporting Rules](#).

¹⁵ Regulation 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (ESMA), amending Decision No 716/2009/EC and repealing Commission Decision No 2009/77/EC (http://www.esma.europa.eu/system/files/Reg_716_2010_ESMA.pdf).