

The ESMA Level 2 Consultation on the AIFM Directive

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Making a Long Story Short

On 13 July 2011, the European Securities and Markets Authority (“ESMA”) published its long-awaited [draft technical advice](#) to the European Commission on possible implementing measures relating to the Alternative Investment Fund Managers Directive (the “AIFMD” – for our overview of the principal provisions of this Directive, please click [here](#)). ESMA’s advice is set out in a highly detailed document stretching to 438 pages and includes proposals on all implementing measures requested by the Commission with the exception of those on the AIFMD provisions affecting non-EU managers, funds, depositaries and delegates, on which ESMA is consulting separately.

The following is an overview of ESMA’s advice, which we have set out as an executive summary followed by a more detailed description of the proposals. Industry participants are invited to provide ESMA with their comments by **13 September 2011**.

Executive Summary

Although ESMA’s draft technical advice takes the form of an industry consultation, its proposals are both extensive and detailed in nature and contain only few variable options, suggesting that the content of the advice may not change much between now and its submission to the European Commission later this year (which must occur, at the latest, by 16 November). Accordingly, relevant firms can already form a reasonably clear view as to the nature and scope of many of the obligations they will face when the AIFMD comes into effect.

The content of ESMA’s proposals is largely unsurprising and few of the proposals are likely to prove controversial among industry participants as the majority of the suggested requirements aim to achieve alignment with MiFID and/or UCITS. Given that the Level 1 Directive has already set the regulatory goalposts and that the Commission has provided ESMA with a very specific advisory mandate, there is limited manoeuvring space for ESMA to materially expand, or soften, the Level 1 requirements.

The headline proposals are as follows:

- AIFM falling below relevant asset-under-management thresholds for authorisation under the AIFMD (€100m, or €500 for unleveraged AIF with a minimum five-year lock-in) may exceed those thresholds temporarily but must notify their regulator whenever this occurs;
- AIFM will need to hold sufficient own funds or professional indemnity insurance to account for a number of specific risks, including the risk of any negligent valuation performed by an appointed external valuer;
- the obligations of AIFM are to be aligned with those of MiFID firms and UCITS management companies in respect of selecting counterparties, execution, order-handling and inducements;
- AIFM must consider a set of minimum criteria when assessing the possibility of conflicts of interest arising, and must maintain an effective conflicts of interest policy;
- AIFM must establish and implement quantitative and/or qualitative risk limits for, and accord a risk profile to, each AIF they manage;
- MiFID and UCITS-equivalent organisational requirements are to apply to AIFM in respect of decision-making procedures, reporting lines, internal control mechanisms and record-keeping procedures;
- senior management, directors and non-executive directors of AIFM are to be given specific responsibilities, which include implementing the investment policy for each AIF, overseeing risk management procedures, and setting an appropriate remuneration policy;
- AIFM may apply different valuation standards in accordance with the requirements and standards of local jurisdictions, but must comply with governance requirements under the AIFMD when setting and applying valuation methodologies;

- an AIFM should be considered to become a letter-box entity as a result of delegating functions either when it can no longer effectively supervise the delegated tasks and manage the associated risks, or when it no longer has the power to take decisions in key areas falling under senior management responsibility;
- financial instruments held in custody by a depositary or a sub-custodian should be considered “lost” if a stated right of ownership over the instruments ceases to exist or never existed, if the AIF has been permanently deprived of its right of ownership, or if the AIF is permanently unable to dispose of the instruments;
- the depositary should not be liable for the loss of financial instruments held in custody if the event which led to the loss did not occur as a failure of the depositary or a sub-custodian to meet its obligations, if the depositary could not have prevented the event by reasonable efforts, and if despite rigorous and comprehensive due diligence, the depositary could not have prevented the loss.

It is worth noting that ESMA is consulting separately on its proposed implementing measures relating to the most controversial provisions in the AIFMD, on passporting and private placement for non-EU AIFM and non-EU AIF. For a large number of firms, the impact of the AIFMD will turn on the final content of those third-country provisions.

The Lamfalussy process

European financial services directives lay down high-level rules and principles, and the detailed application of their provisions is generally determined in additional legislative measures and guidance. This follows the so-called “Lamfalussy process”, which was used for the adoption of MiFID and UCITS IV and which is presently underway in the case of the AIFMD (and will conclude at a European level on 22 July 2013, when the AIFMD takes effect).

In the Lamfalussy process, a so-called “Level 1” framework directive is negotiated between, and adopted by, the European Council and Parliament (in the case of the AIFMD, this was adopted in November 2010), and then supplemented by more detailed “Level 2” measures consisting in further legislation adopted by the European Commission on the basis of technical advice received from a relevant European supervisory authority (in the case of the AIFMD this is ESMA, which has published the draft technical advice summarised in this overview). At “Level 3” of the process, national regulators working within the relevant supervisory authority (which again, will be ESMA in the case of the AIFMD) produce guidance on how to apply the new legislative regime, and “Level 4” of the process consists in implementation and enforcement of the regime at a national level within EU Member States.

ESMA consultation

In December 2010, the European Commission requested ESMA’s predecessor, the Committee of European Securities Regulators (“CESR”), to provide it with technical advice on possible implementing measures for the AIFMD, which led to an initial round of industry dialogue between ESMA (acting through four AIFMD taskforces) and industry participants. On 13 July 2011, ESMA published its draft technical advice to the Commission on possible measures for implementing the AIFMD, inviting further industry comment by 13 September 2011.

The following is an overview of the proposals contained in ESMA’s draft technical advice.

Article 3 exemptions

Article 3 of the AIFMD deals with circumstances under which Alternative Investment Fund Managers (“AIFM”) may be exempt from the obligation to obtain authorisation because the assets held by Alternative Investment Funds (“AIF”) they manage are below certain thresholds. The threshold for AIFM whose holdings include assets acquired through leverage is €100 million. If, however, AIFM-managed assets are both unleveraged and have no redemption rights exercisable for five years after initial investment, then the threshold is €500 million of assets under management. AIFM whose assets under management are below these thresholds may opt in to AIFMD authorisation should they wish to do so.

Basis for calculation

The onus will be on the AIFM to establish whether it can claim exemption from the AIFMD. Regulatory authorities will, however, have the right to check that an AIFM is calculating and monitoring assets under management correctly.

ESMA envisages differentiation between open-ended funds, where regularly calculated net asset values may serve to calculate assets under management, and closed-ended funds where net asset value may not be the most suitable measure. Acquisition costs of assets held, or commitment costs less realisations at cost, are suggested as possible alternatives.

UCITS managed by an AIFM would be excluded from the calculation of assets under management, but “exempt” AIF covered by Article 61 grandfathering provisions would have to be included. ESMA is proposing that AIFM be permitted to exclude from the calculation investments by AIF in other AIF managed by the same AIFM (given that, on a look-through basis, there is only one set of underlying assets to be included in the calculation), with the proviso that leveraged exposure to other AIF, and any exposure created through the use of financial derivative instruments, must always be included.

Timing of calculation, temporary crossing of thresholds

ESMA recommends that the total value of assets under management should be calculated at least annually. The latest available net asset value must be produced within 12 months of the threshold calculation date and the timing must be consistent from year to year.

ESMA does not think it sensible to require immediate authorisation if temporary movements of assets under management lead to a threshold being breached. Notification will be required in every case, but provided an AIFM has good reason to believe that the change will be reversed within 3 months, authorisation will not be required.

Registration

All AIFM that are not required to obtain authorisation under the AIFMD on the basis that their assets under management do not reach a relevant threshold are nonetheless required to register with national authorities. ESMA lists the types of information that will need to be provided by these AIFM, which includes information on the AIF they manage and their investment strategies.

AIFM which are authorised under the AIFMD and which fall under a relevant threshold will continue to be authorised and will not need to notify a national authority unless they wish to be de-authorised.

General operating conditions

Own funds and insurance to cover professional liability risks

Article 9(7) of the AIFMD requires AIFM to cover potential professional liability risks by holding an appropriate amount of additional own funds, or by taking out professional indemnity insurance. ESMA's advice includes a proposed list of risks to be covered by own funds or insurance, which include the risk of fraud by relevant persons, the risk of negligent failure to meet obligations towards investors or clients, and the risk of business disruption or system failures. Significantly, ESMA suggests that AIFM should also account for the risk of any negligent valuation performed by an appointed external valuer.

AIFM are to implement appropriate operational risk management policies and procedures. Two options are proposed for the calculation of required own funds to cover relevant risks: either an amount equal to 0.01% of assets under management, or an amount equal to 0.0015% of assets under management plus 2% of relevant income (although national authorities may lower these requirements under certain circumstances in either case).

Any indemnity insurance taken out by an AIFM must be wide enough to cover relevant risks under the AIFMD and must not be provided by an affiliated company (unless that company in turn lays off its exposure, e.g. through reinsurance). Any defined excess must be covered by the AIFM's own funds, and the insurance coverage must satisfy specified amounts per claim and for claims in aggregate per year.

General principles

ESMA's proposals relating to general operating principles have, where possible, been aligned with the equivalent principles under the MiFID and UCITS regimes, recognising that many entities which currently operate as UCITS managers or MiFID firms will require authorisation as AIFM under the AIFMD¹.

Duty to act in the interests of the AIF, investors and the market

AIFM are to take appropriate measures to avoid malpractices (such as market timing and late trading) that might reasonably be expected to affect the stability and integrity of the market, and are required to prevent undue costs (such as excessive trading costs) to the AIF and its investors. They should ensure a high level of due diligence in the selection and monitoring of investments (in accordance with regularly updated written policies and procedures) and have professional expertise in the assets in which AIF are invested. Specific additional due diligence requirements (such as an obligation to draw up a business plan for the life duration of the AIF) apply for AIFM which manage AIF that invest in long-duration, less liquid assets such as real estate or partnership interests.

Selection of counterparties, execution and order-handling

Other requirements based on equivalent rules in the MiFID and/or UCITS regimes are the requirement to provide investors with information in a durable medium on the execution of any subscription or redemption, the requirement to exercise due care, skill and diligence in selecting and appointing counterparties, the obligations of best execution and prompt, fair and expeditious order-handling, and the principle of fair aggregation of trading orders (although ESMA recognises that these obligations may not be relevant when the AIFM invests in real estate or partnership interests and the investment is made after extensive negotiations on the terms of the investment agreement).

Inducements

ESMA also proposes to introduce provisions on inducements designed to align the position of AIFM with those of UCITS managers and MiFID firms. Accordingly, AIFM will only be able to pay or receive (1) fees, commissions or non-monetary benefits to or from the AIF (or a person acting on behalf of the AIF); (2) fees, commissions or non-monetary benefits to or from a third party where the payment is comprehensively and accurately disclosed to investors in the AIF, is designed to enhance the quality of the relevant service and does not impair the AIFM's duty to act in the best interests of the AIF; and (3) proper fees which enable or are necessary to the provision of the relevant service (e.g. custody costs or settlement fees) and which do not conflict with the AIFM's duty to act in the best interests of the AIF.

These provisions go further than the equivalent UCITS inducement provisions in that they apply to marketing fees. So, for example, where an investor pays subscription fees to an AIFM which are passed on to intermediaries for the marketing of the relevant AIF, the requirements under heading (2) above will apply. ESMA explains this on the basis that, while the Commission's Packaged Retail

¹ It appears that under Article 6 of the AIFMD, a UCITS management company will be capable of dual authorisation as a UCITS manager and an AIFM, whereas a MiFID firm will not be capable of dual authorisation as a MiFID firm and as an AIFM. On this reading of the AIFMD, MiFID firms that wish to become AIFM will need to vary their permissions to the extent that these exceed the range of activities permitted to be carried on by AIFM under Article 6.

Investment Products (“PRIPs”) initiative will cover marketing fees made or received by UCITS managers, PRIPs will not apply to AIFM marketing AIF to professional investors.

Fair treatment by an AIFM

ESMA proposes two possible approaches to “fair treatment”: the first would consist only in a prohibition on AIFM according any investor preferential treatment that would have an overall material disadvantage to other investors; whereas the second approach would include this prohibition, but would also include a number of other (unspecified) obligations relating to fair treatment of investors which would arise on a case-by-case basis. In either case, the issuing of different share classes which each give investors different rights and obligations in respect of redemptions, minimum subscription amounts or the payment of management fees, or the granting of preferential rights to seed investors (who assume a greater level of risk than subsequent investors) will not result in preferential treatment of certain investors giving rise to a material overall disadvantage to the other investors. It is worth noting that this does not clarify whether (and if so, to what extent) the practice of entering into side letters with specific investors will be permitted (e.g. on the condition that the side letter arrangement is disclosed in accordance with Article 12(1) of the AIFMD).

Conflicts of interest

ESMA proposes to introduce a set of minimum criteria which AIFM must consider when assessing the possibility of conflicts of interest arising. These criteria focus principally on the question whether the AIFM, a relevant person or a person directly or indirectly linked by way of control to the AIFM has an interest in any services or activities, or itself carries out any activities, which are incompatible with the interests of the AIF it manages. A number of concrete examples are provided to illustrate possible conflicts of interest (for example, the AIFM invests in an asset which it has an interest in but which is not an advantageous investment for the AIF and its investors, or the AIFM delegates activities to an affiliated company which is poorly suited to undertake them). AIFM are also required to establish, implement and maintain an effective conflicts of interest policy, and ensure that voting rights in investments held by an AIF are exercised to the exclusive benefit of the AIF and its investors concerned.

Where conflicts do arise, they must be managed appropriately. In particular, the procedures and measures established for the management of conflicts of interest should be designed to ensure that relevant persons engaged in different business activities involving a conflict of interest carry on these activities at a level of independence appropriate to the size and activities of the AIFM and its group, and to the materiality of the risk of damage to the interests of the AIF or its investors. For example, this may include preventing or controlling the exchange of information between such persons, or removing any direct link between their remuneration. Actual or potential conflicts of interest entailing a material risk of damage to the interests of one or more AIF or its investors must be appropriately recorded, and all conflicts and their sources must be disclosed to investors in a durable medium or (subject to certain conditions) via a website.

Risk management

The proposed provisions on risk management largely follow those which apply to UCITS managers. AIFM must establish and implement quantitative and/or qualitative risk limits for each AIF they manage, which must cover market, credit, liquidity, counterparty and operational risks (the latter including, for example, the risk of fraud, the risk of information technology failure, or the risk of key persons departing). A risk profile must be accorded to the AIF in accordance with these limits, and compliance of the risk profile with the risk limits must be monitored on an ongoing basis and reported to the AIFM’s governing body and, if relevant, its supervisory function (e.g. its non-executive directors).

In order to manage and monitor relevant risks, AIFM must implement an effective risk management policy and corresponding procedures. The policy must include certain elements (e.g. a description of how responsibilities are allocated within the AIFM and a justification of how the risk limits for an AIF are aligned with any risk profile disclosed to investors), and must be periodically assessed, monitored and reviewed. Risk management procedures must, in the event of actual or anticipated breaches of risk limits of the AIF, result in timely remedial action in the best interests of investors, and their possible vulnerability must be assessed through stress tests, back tests and scenario analyses.

ESMA has also proposed details to supplement Article 15(1) of the AIFMD, which requires AIFM to functionally and hierarchically separate their risk management from their operating units, including from the portfolio management function. This separation must be overseen by the governing body of the AIFM, which must ensure that individuals carrying out risk management functions neither undertake activities in, nor are supervised by individuals in, the operational units (including the portfolio management function) of the AIFM. The remuneration of individuals carrying out risk management functions must be set independently of the performance of other, conflicting business areas, and the remuneration of senior risk managers must be directly overseen by the remuneration committee (where the AIFM is sufficiently large and complex to have such a committee). If the governing body of the AIFM identifies a potential for material conflicts of interest between the risk management function and other business areas, it must put in place specified safeguards to ensure the independent performance of risk management functions, including ensuring independent access to data by risk management staff and independent review of the key risk management function. Larger AIFM will, in such cases, be required to commission a review of the risk management function by the internal audit function or an external third party, and establish an appropriately resourced risk committee.

Liquidity management

ESMA proposes that AIFMs be required, for each AIF they manage that is not an unleveraged closed-ended AIF, to adopt appropriate liquidity management policies and procedures which enable the AIFM to monitor the liquidity risk of the AIF, which comply with underlying obligations to investors, counterparties, creditors and other parties, and which take into account the investment strategy, liquidity profile and redemption policy of each AIF. The proposals contain a number of specific requirements which these policies and procedures must seek to achieve, including requirements to maintain a level of liquidity in the AIF that is appropriate to its underlying obligations; to monitor the liquidity profile of the AIF; to monitor the liquidity management approach of investment managers of underlying collective investment undertakings in which the AIF invests; to measure qualitative and quantitative liquidity risks; to ensure redemption policies are disclosed to investors; to identify liquidity tools that are appropriate in normal and exceptional circumstances respectively; and to identify conflicts of interest between redeeming investors and those who

retain their investment in the AIF. AIFM must also set, implement, and monitor compliance with, liquidity risk limits, and subject these to stress tests. These limits are not intended to constitute a liquidity management tool, but rather a tool for monitoring liquidity.

Further proposals in this area include a proposal that the investment strategy, liquidity profile and redemption policy of an AIF should only be considered to be aligned (as required by Article 16(2) of the AIFMD) if investors can redeem their investments in a way which allows for fair treatment of other investors and accords with the AIF redemption policy. Relevant factors here are the impact on underlying prices and/or spreads of AIF assets, and the appropriate use of gates, suspensions and side pockets. ESMA considers these latter mechanisms to fall within the definition of "special arrangement", i.e. an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF and which must be periodically disclosed to investors.

Investment in securitisation positions

The proposals in this area seek to achieve alignment with the Capital Requirements Directive and the Solvency II Directive. Article 17(1) of the AIFMD provides that an AIFM may only invest in securities or other instruments based on repackaged loans on behalf of one or more AIF if the originator, sponsor or original lender retains a net economic interest ("skin in the game") of not less than 5%. ESMA's advice on this provision relates to the detailed criteria which sponsors and credit originators must fulfil; requirements relating to transparency and disclosure of the retention by the originator, sponsor or original lender; risk and liquidity requirements relating to investments in securitisation positions; monitoring and stress-testing of those investments; reporting within the AIFM to senior management; and grandfathering (which will allow AIFM who have acquired investments in securitisation positions issued prior to 1 January 2011 to defer compliance with applicable requirements under the AIFMD until 31 December 2014, where new underlying exposures are added or substituted after that date).

ESMA also proposes that these requirements should apply to UCITS managers, and that corresponding amendments be made to the UCITS regime.

Organisational requirements

The technical advice on organisational requirements follows corresponding provisions in the UCITS and MiFID regimes. Accordingly, AIFM must have decision-making procedures and an organisational structure with clear and documented reporting lines, responsibilities and functions, ensure proper awareness of applicable procedures, adequate internal control mechanisms to secure compliance, effective internal reporting and information flows with third parties, and appropriate record-keeping procedures. These requirements should take into account the nature, scale and complexity of the business of the AIFM, and the nature and range of services and activities it undertakes in the course of that business.

AIFM must also be in a position to ensure the security and confidentiality of information, maintain a business continuity policy, establish accounting policies and procedures reflecting a true and fair view of their financial position, and monitor the adequacy and effectiveness of their systems and controls. ESMA has also proposed detailed record-keeping requirements in relation to portfolio transactions and subscription and redemption orders (including an obligation to retain records for a minimum of five years).

Personnel employed are to have the skills, knowledge and expertise necessary for the discharge of their responsibilities. Senior management and, where appropriate, the supervisory function (e.g. non-executive directors) are responsible for the AIFM's compliance with its obligations under the AIFMD. A number of specific responsibilities are allocated to senior management, which include implementing the investment policy and approving the investment strategies for each AIF, establishing appropriate valuation procedures, ensuring the AIFM has an effective compliance function, overseeing risk management policies and procedures, and setting an appropriate remuneration policy in accordance with AIFMD requirements. The compliance function of the AIFM must be permanent in nature, possess adequate resources and expertise, and have a compliance officer appointed to it who must report to senior management. In larger and more complex AIFM, the compliance officer will be required to refrain from any involvement in services or activities monitored by the compliance function, and must be remunerated in a way which does not compromise the officer's objectivity.

Suitable electronic systems should be in place to allow the AIFM to record each portfolio transaction or subscription or redemption order. AIF accounting must allow all assets and liabilities of the AIF to be directly identified at all times. Larger and more complex AIFM will be required to establish an internal audit function.

All AIFM must have in place personal account dealing arrangements aimed at preventing certain activities on the part of persons (such as directors of AIFM) who are involved in transactions that may give rise to a conflict of interest or who have access to inside information or other confidential information relating to AIF or transactions with or for AIF. The proposed provisions are based on equivalent provisions in the UCITS regime, although the AIFMD wording goes further in that it applies to personal transactions not only with financial instruments but also with other assets (e.g. partnership interests).

Valuation

ESMA's proposed Level 2 measures relating to valuation have been kept general to allow AIFM to apply different valuation standards in accordance with the requirements and standards of local jurisdictions (as they apply both in respect of the valuation of assets within the portfolio of an AIF and the calculation of the net asset value of an AIF) and the particular characteristics of the assets held by a relevant AIF.

AIFM are therefore subject to a high-level obligation to ensure that, for each AIF they manage, written policies and procedures are in place to ensure a sound, transparent and appropriately documented valuation process. Any valuation methodology selected must be adapted to the category of the asset to be valued, and the AIFM's valuation policy must clearly set out the roles of all parties involved. There must be an appropriate exchange of information with any externally appointed valuer, and where the AIFM itself carries out the valuation, safeguards must be in place to ensure that the performance of the valuation task is functionally independent from other parts of the AIFM's operations.

Valuation models must be approved by senior management and explained in the valuation policies and procedures. These policies and procedures must be applied consistently across all assets within an AIF and all AIF managed by the AIFM, and reviewed periodically. AIFM must ensure that the values of all assets held by AIF they manage are fair and appropriate, and should ensure that the net asset value is calculated on the occasion of each issue or subscription of units or shares, but at least once a year.

Valuation of assets that are financial instruments should occur at the same time that the net asset value is calculated, whereas for all other types of asset, valuation should generally occur at least once a year. ESMA recognises that the value of the assets that are financial instruments is often established on a daily basis to allow equally frequent calculation of the net asset value (for example, in the case of many open-ended funds), whereas this is not usually the case of more illiquid types of asset (i.e. such as real estate). Assets of this latter type should not therefore require valuation more frequently than once a year.

Where an external valuer is appointed to value an asset, the professional guarantees to be provided by the valuer in accordance with Article 19(5)(b) of the AIFMD must be in written form, and should include evidence of the valuer's qualification and capability to perform the valuation in question.

Delegation

The draft technical advice clarifies that the requirements in Article 20 of the AIFMD which AIFM must comply with for the purposes of delegating functions apply to the delegation of tasks which would otherwise be undertaken by the AIFM and which are critical or important for the proper performance of the functions the AIFM provides to an AIF. A function or task is critical or important if a defect or failure in its performance would materially impair continued compliance of the AIFM with the conditions and obligations of its authorisation or its other obligations under the AIFMD, or its financial soundness or continuity of the functions it performs. Services which an AIFM may provide under the AIFMD in addition to collective portfolio management of AIF (such as advisory services) are not to be considered critical or important.

A number of additional general principles AIFM must comply with when delegating functions and tasks are proposed. These are in line with MiFID and include a prohibition on senior management delegating its responsibility and on the AIFM altering its obligations under the AIFMD towards investors or undermining its authorisation conditions under the AIFMD; an obligation on the AIFM to ensure that the delegate acts in accordance with applicable legal and regulatory rules and that delegated tasks can be transferred to another third party or back to the AIFM where the delegation arrangement is terminated; a requirement for a written delegation agreement containing provisions on instructions to the delegate and termination of the agreement; and a requirement for the AIFM to give its written consent to any sub-delegation.

As concerns the requirement in Article 20(1)(a) of the AIFMD for an objective reason for the delegation, the advice sets out two options for consultation. The first takes a flexible approach according to which the AIFM must demonstrate that the delegation allows "a more efficient conduct of the AIFM's management of the AIF". The second option sets out an indicative, non-exhaustive list of possible objective reasons, including optimisation of business functions and processes, cost saving, expertise of the delegate and access of the delegate to global trading capabilities.

ESMA indicates that the delegate can be assumed to be of "sufficiently good repute" for the purposes of Article 20(1)(b) if it is established in the EU and authorised or registered for the delegated tasks, and the issue of its repute has been reviewed by the relevant supervisory authority as part of the authorisation procedure. In all other cases, the AIFM has to evaluate whether the delegate complies with this condition, which will depend principally on whether the persons who effectively conduct the business of the delegate are sufficiently experienced and of sufficiently good repute.

For the purposes of Article 20(1)(c), UCITS managers, MiFID firms, credit institutions and other AIFM (but not UCITS investment companies or internally managed AIF) are to be considered as "authorised or registered for asset management and subject to supervision". In order to ensure that the delegation does not prevent the effective supervision of the AIFM or the AIFM from acting, or the AIF from being managed, in the best interests of investors (in accordance with Article 20(1)(e)), the AIFM, its auditors and relevant competent authorities must have access to data relating to the delegation and to the delegate's business premises; the delegate must cooperate with the competent authorities and the AIFM must make all relevant information available to the authorities for supervisory purposes; and any conflict between the interests of the delegate and those of the AIFM of the investors must be properly identified, managed and monitored.

ESMA considers that the risk of the delegation giving rise to a material conflict of interest (as per Article 20(2)(b) of the AIFMD) must be considered, in particular, where the AIFM and the delegate are in the same corporate group and the delegate can control the AIFM or influence its actions, or where an investor and the delegate are in the same corporate group and the investor can control the delegate or influence its actions. The portfolio or risk management tasks of the delegate should be considered functionally and hierarchically separate from other potentially conflicting tasks (such as the compliance or audit function, or market-making or underwriting) where individuals within the delegate do not perform tasks in both areas and do not perform risk management tasks under the supervision of persons in an operational department, and where this separation is ensured by the governing body of the delegate.

As concerns Article 20(3) of the AIFMD, ESMA considers that there are two situations in which an AIFM should be considered to be a letter-box entity. Firstly, when the AIFM is no longer able to effectively supervise the delegated tasks and to manage the risks associated with the delegation; and secondly, when the AIFM no longer has the power to take decisions in key areas that fall under the responsibility of senior management or to perform senior management functions.

Depositaries

Appointment of a depositary

ESMA has used the requirements relating to depositary agreements under the UCITS regime as the starting point for its proposals in this area, but has suggested a number of provisions that differ from those in the UCITS regime to take into account the specificities of AIF. The principal reason for this diversion from the UCITS position is that, unlike for UCITS, the types of assets in which an AIF

can invest are not harmonised, and AIF can invest in an extremely wide and diverse range of assets. ESMA has decided not to define a model agreement for the appointment of a depositary by an AIFM, on the basis that it would not be possible to define a standard model that could apply to the wide range of AIF legal structures and investment strategies, and the differing nature of ownership rights across jurisdictions.

Instead, ESMA has proposed a list of the particulars which must be included in a depositary agreement. These include a description of the services to be provided and the assets concerned, provisions confirming the depositary's liability position as required under the AIFMD, and provisions allowing for an exchange of information between the depositary, the AIFM and relevant AIF, and protecting the confidentiality of that information. A separate written agreement will not be required in respect of each AIF; rather, the AIFM and the depositary can enter into a framework agreement listing the AIF managed by the AIFM to which the agreement applies.

Duties of the depositary

Cash flow monitoring

The AIFM is required to provide the depositary with all the information the depositary requires to comply with its cash-flow-monitoring obligations under the AIFMD, both upon appointing the depositary as well as on the opening of any new cash account, and the depositary must be able to receive information on cash accounts directly from third-party account providers.

As concerns the depositary's cash-flow monitoring obligations, ESMA is consulting on two options. One option is to consider the depositary as a central hub where all information related to the AIF's cash flows is centralised, recorded and reconciled in order to ensure an effective and proper monitoring of all cash flows. The second option would require the depositary to ensure there are procedures in place to appropriately monitor the AIF's cash flows and that these procedures are effectively implemented and periodically reviewed. The depositary would, in particular, be required to oversee the reconciliation procedure and ensure remedial action is taken without undue delay whenever a discrepancy is identified.

For the purposes of ensuring that an AIF's cash is properly booked, the depositary must ascertain that any account has been opened with either a central bank, a credit institution, a bank authorised in a third country, or any bank or credit institution in a non-EU country where the AIF has had to open an account in relation to an investment decision. ESMA has also proposed to limit the depositary's obligation to ensure that payments made by investors upon their subscription have been received by the AIF to an obligation to verify relevant information at the level of the AIF's register.

Safekeeping

The financial instruments which a depositary should hold in custody (as opposed to exercise title verification in respect of) are transferable securities, money market instruments and units of collective investment undertakings (provided none of these are provided as collateral), and instruments that can be physically delivered to the depositary. ESMA proposes that these instruments should either be registered or held in an account in the name of the depositary, or that alternatively, the depositary (itself or through a sub-custodian) be capable of transferring title or an interest in the instruments by means of a book entry on a register maintained by a relevant settlement system. It is also proposed that financial instruments should not be held in custody if they are provided under certain types of title transfer collateral arrangement or financial collateral arrangement. The obligations of the depositary in relation to instruments held in custody include an obligation to ensure the instruments are properly registered and held with due care, and that all relevant custody risks are monitored.

For all assets that do not fall under the definition of financial instruments to be held in custody, the depositary is first required to verify the right of ownership of the AIF or the AIFM acting behalf of the AIF. For this purpose, the AIFM and the depositary must ensure the depositary has access to all relevant information (including from third parties such as prime brokers), and the depositary must maintain a register of all assets for which ownership has been verified. ESMA suggests that the depositary could be required to put in place procedures enabling it to receive information on transactions in such assets, or that alternatively, the depositary could simply be required to mirror all such transactions in a position-keeping record.

Oversight

The depositary is required to ensure that an AIF, its AIFM or an appointed third party implements appropriate procedures for reconciling subscription or redemption orders with proceeds received or paid, and must ascertain that a corresponding number of units or shares is issued or cancelled. The depositary must also verify on an ongoing basis that appropriate valuation procedures are implemented in accordance with AIFMD requirements, and must operate procedures to verify that the AIF and the AIFM comply with applicable legal and regulatory rules and with the AIF's rules and instruments of incorporation. In order to verify the timely settlement of transactions, the depositary should set up a procedure to detect any situation where consideration is not remitted to the AIF within usual time limits, and in such cases notify the AIFM and request the restitution of the financial instruments from the counterparty. The depositary must also ensure net income is calculated in accordance with applicable requirements, ensure appropriate measures are taken where the AIF's auditors have expressed reserves on the annual financial statements, and check the completeness and accuracy of dividend payments (and where relevant, of the carried interest).

The oversight procedures put in place by the depositary must be regularly updated and should be proportionate to the AIF and the assets in which it invests. The oversight exercised by the depositary consists in *ex post* controls and verification of processes and procedures carried out by the AIFM, the AIF or an appointed third party, and the depositary should have escalation procedures to deal with any irregularities that may be detected.

Due diligence on delegates

ESMA further proposes a number of requirements for the due diligence a depositary must carry out on a third party to which it wishes to delegate safekeeping functions. The depositary must assess the legal framework that applies to the delegate (including country risk, custody risk and enforceability of contractual agreements), focusing in particular on the potential consequences of any

insolvency of the delegate. The ability of the delegate to apply due care in the safekeeping of instruments, the delegate's financial strength and renown, and its operational and technological capabilities must also be assessed, and the delegate must be monitored by the depositary on an ongoing basis. Contingency plans identifying alternative providers must be in place, and the depositary must terminate the delegation agreement if this is in the best interests of the AIF and its investors where the delegate no longer complies with prerequisite requirements.

Segregation by delegates

Where safekeeping functions have been delegated partly or totally to a third party, the depositary must ensure that the delegate segregates the assets of the depositary's clients from its own assets and from the assets of the depositary. The depositary must verify that the delegate has records and accounts which demonstrate compliance with this requirement, conducts regular reconciliations between its internal accounts and records and those of any sub-delegate, ensures that instruments it keeps for the depositary's clients are identifiable separately from instruments belonging to the sub-delegate, and deposits cash belonging to the depositary's clients in a central bank, a credit institution or a bank authorised in a non-EU country in accounts identified separately from any accounts used to hold cash belonging to the third party or, where relevant, the sub-delegate.

Depositary liability

Under Article 21 of the AIFMD, the depositary's liability can be triggered either in the event of failure or negligence on the part of the depositary, or in the event of loss of a financial instrument held in custody by the depositary itself or a sub-custodian.

Loss of financial instruments

ESMA proposes that financial instruments held in custody by the depositary or by a sub-custodian should be considered "lost" if (1) a stated right of ownership proves to be unfounded because it either ceases to exist or never existed; (2) the AIF has been permanently deprived of its right of ownership over the financial instruments; or (3) the AIF is permanently unable to directly or indirectly dispose of the financial instruments.

Under the last (i.e. third) condition, there will be no loss if the instrument in question is substituted by or converted into another financial instrument or instruments (for example in situations where shares are cancelled and replaced by the issue of new shares in a company reorganisation). Where a sub-custodian becomes insolvent, the loss will be deemed to occur as soon as one of the three conditions is met or, at the latest, at the end of the insolvency proceedings. In the case of fraud whereby the financial instruments have never existed or have never been attributed to the AIF, all three conditions should be deemed to be met.

External events beyond reasonable control

The depositary will not be liable for the loss of financial instruments held in custody by itself or by a sub-custodian if it can demonstrate that (1) the event which led to the loss did not occur as a result of an act or omission of the depositary or one of its sub-custodians to meet its obligations (i.e. the event was "external", examples being a market closure or settlement system failure); (2) the event was beyond the depositary's reasonable control, i.e. it could not have prevented its occurrence by reasonable efforts; and (3) despite rigorous and comprehensive due diligence, it could not have prevented the loss.

For the purposes of the second part of the test, the depositary will be deemed to have made "reasonable efforts" if it has in place appropriate means to identify and monitor events deemed beyond its control which could lead to a loss, regularly updates its assessment of those events, and takes appropriate action when needed.

ESMA considers that where a sub-custodian becomes insolvent, the financial instruments held in custody by that entity should not automatically be deemed lost since there is a reasonable chance they will be recovered at the end of the legal proceedings (by virtue notably of the sub-custodian's obligation to comply with the segregation requirements outlined above). However, such instruments should nonetheless be considered lost where the sub-custodian failed to implement the segregation rules, the law of the country where the instruments were held in custody does not recognise the effects of such segregation requirements, or to the extent that they are lost due to disruption in the entity's activity in connection with its default.

Objective reasons to contract a discharge

Article 21(13) of the AIFMD allows the depositary to discharge itself from liability for loss of financial instruments by entering into an appropriate contractual arrangement with a sub-custodian and a further contractual arrangement with the AIF (or the AIFM acting on its behalf) that states an objective reason for the discharge. ESMA proposes that there should be such an objective reason either where (1) the depositary had no other option but to delegate its custody duties to a third party (e.g. as a result of legal constraints) or it has agreed with the AIF (or the AIFM, acting on behalf of the AIF) in a written agreement that it is in the best interests of the AIF and its investors to delegate such duties (e.g. if the delegate is in a country where the depositary does not operate); or (2) where the AIF (or the AIFM, acting on behalf of the AIF) and the depositary have agreed in a written agreement that the depositary can discharge its responsibility.

Calculating leverage and exposure of AIF

The concept of leverage is referred to in various provisions of the AIFMD, including those which require an AIFM to include information on its leverage policy in its application for authorisation, to set a maximum level of leverage it may employ for each AIF, to report the use of leverage to investors and competent authorities, and to demonstrate that leverage levels for each AIF are reasonable and complied with. The AIFMD also uses the phrases "increases the exposure" when referring to leverage (i.e. when the use of leveraged instruments, such as derivatives, increases the exposure of the AIF beyond its net asset value).

In short, ESMA considers that leverage can be considered as the additional exposure gained through any form of contractual or other legal relationship that gives AIF the opportunity to earn greater returns or suffer greater losses than would otherwise have been the case. However, this magnifying factor will sometimes have limits, in particular where an AIF utilises options, financial

instruments with optionality or hold positions in the form of contracts or participations where the invested capital of the AIF is the limit of that exposure. “Bounded” exposure of this type can be obtained through a call spread (a combination of a long position in one call and a short position in another call, both of which reference the same underlying asset), through which the AIF is exposed to the potential of a known profit or loss from the instrument.

ESMA has rejected a Value at Risk (“VaR”) approach to the calculation of global exposure (on the basis that leverage of AIF may include cash borrowings and derivative positions, and that the VaR approach is not sufficiently robust in stressed market conditions) whereas most (if not all) AIFM will be able to calculate the exposure of their AIF using the commitment approach. When calculating exposure, AIFM should “look through” corporate structures to the extent that those structures have recourse to the AIF via cross-collateralisation or guarantees, and “look through” derivative or other instruments where leverage is embedded in the contract so as to convert to an equivalent underlying position. Hedging arrangements can be considered to reduce the exposure of the AIF in specific circumstances, in accordance with the CESR Guidelines on Risk Measurement and Calculation of Global Exposure to Counterparty Risk for UCITS. Temporary borrowing fully covered by capital commitments by an AIF’s investors should not be considered to increase the exposure of the AIF.

Limits to leverage and other restrictions on the management of AIF

Article 25(3) of the AIFMD requires competent authorities, under certain conditions, to impose limits on the level of leverage AIFM may employ or other restrictions on the management of the AIF to limit the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or risks of disorderly markets. ESMA provides illustrative examples of circumstances in which competent authorities may need to impose such restrictions, including where the use of leverage by an AIFM constitutes an important source of market, liquidity or counterparty risk to a financial institution, and where it contributes to a downward spiral in the prices of financial instruments. Competent authorities are to take into account any concentration of risks in certain markets in which AIF operate, contagion risks to other markets, and liquidity issues in given markets or sectors; but should also take into consideration any pro-cyclical effects and any impact on the stability and integrity of the financial system which may result from imposing restrictions or from the timing of those restrictions.

Transparency requirements

Annual reporting

ESMA’s advice contains a number of proposals relating to the content of an AIF’s annual report and the remuneration disclosure required under Article 22 of the AIFMD. Recognising that accounting requirements vary from jurisdiction to jurisdiction, the proposed requirements reflect recognised best practices, include key elements of financial statements and a non-exhaustive list of underlying line items, and are intended to be applied in accordance with the size, structure and business model of the AIF in question. The requirements cover general principles for the annual report (which give precedence to the accounting rules contained in the AIF rules or instruments of incorporation to the extent that they are compatible with the accounting standards in the jurisdiction where the AIF is located); reporting of material changes in reportable items; and the content and format of the balance sheet, of the income and expenditure account, of the report on activities for the financial year, and of the remuneration disclosure.

Disclosure to investors

ESMA’s advice on disclosure obligations towards investors specifies detailed requirements on the content, format and regularity of the disclosures required under Article 23(4) and (5) of the AIFMD. These requirements relate to the disclosure to investors of the percentage of the AIF’s assets which are subject to special arrangements arising from their illiquid nature; any new arrangements for managing the liquidity of the AIF; the current risk profile of the AIFM and risk management systems employed by the AIFM to manage these risks; the total amount of leverage employed by an AIF; and any changes to the maximum amount of leverage the AIFM may employ on behalf of the AIF as well as any right of reuse of collateral or any guarantee granted under the leveraging arrangements.

Reporting to competent authorities

As concerns reporting to competent authorities under Article 24 of the AIFMD, ESMA’s advice covers the format and content of quarterly reporting under Article 24(1), which must include information on the main types of instrument in which the AIFM is trading, the markets of which it is a member or where it actively trades, and the diversification of the AIF’s portfolio (including its principal exposures and most important concentrations). The advice also proposes quarterly reporting under Article 24(2), which must include information on liquidity and risk management arrangements, the risk profile of the AIF, the main categories of assets held by the AIF, the results of stress tests, and leveraging arrangements (where the AIF uses leverage on a substantial basis). Annex V of the consultation paper contains a reporting template (based on the 2010 IOSCO template for hedge fund reporting) specifically prepared by ESMA for this purpose.

ESMA also provides a set of non-exhaustive criteria for determining when an AIF uses leverage “on a substantial basis”. The criteria to be considered include the type of AIF and its nature, scale and complexity; the investment strategy employed by the AIFM for that AIF; the market conditions in which the AIFM and AIF operate; whether the use of leverage could constitute an important source of market risk, liquidity risk or counterparty risk to a credit institution or other systemically important institution; and whether the use of leverage could contribute to the aggravation of, or a downward spiral in, the prices of financial instruments, or to the build-up of systemic risk in the financial system or a risk of disorderly markets.

If you would like to discuss any points arising from the ESMA consultation, please do get in touch with one of us or with your usual CMS contact.

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