ESMA Issues Draft Technical Advice on Implementing Measures for the Alternative Investment Fund Managers Directive ("AIFMD")

After the hiatus that followed the agreeing of a text of the AIFMD in autumn 2010, the pace of events has recently quickened. The official text of the AIFMD was published in the Official Journal of the European Union on 1 July 2011, and this has clarified that Member States have until 22 July 2013 to implement the AIFMD in their own domestic legislation. And on 13 July 2011, the European Securities and Markets Authority ("ESMA") issued a consultation paper setting out ESMA's proposals for possible implementing measures for the AIFMD. Responses to the 72 questions raised by ESMA are required by 13 September 2011.

ESMA's consultation paper follows a request for assistance on the content of the implementing measures from the European Commission ("Commission"). Under the AIFMD, the Commission is required to produce further, more detailed material ("Level 2 provisions") covering various aspects of the AIFMD that the original 'framework' directive deals with at a higher level. This has been the format followed in other directives under the 'Lamfalussy Process', which is designed to achieve greater harmonisation of implementation in the Member States: for example, in the case of the Markets in Financial Instruments Directive ("MiFID"), where the original directive was followed by an implementing directive. ESMA's final advice, which it aims to submit by 16 November 2011, is likely to form the substance of the measures finally adopted by the Commission, which are anticipated to appear in the second half of 2012.

The Commission's original request was divided into four parts:

- General provisions, authorisation and operating conditions;
- Depositary;
- Leverage and transparency requirements; and
- Supervision.

ESMA's draft advice covers the first three of these parts, but not the fourth. This is because the majority of the measures in the fourth part concern the operation of the marketing passport for third-country entities, and as this passport will not come into effect until July 2015 at the earliest, these measures are seen as less urgent. However, ESMA will be publishing a separate consultation later in the summer on implementing measures relating to the co-operation arrangements between competent authorities (regulators) in Member States and supervisory authorities of non-EU funds and fund managers, as these arrangements will need to be in place by 22 July 2013.

I. General provisions, authorisation and operating conditions

a. AIFMD Article 3 Issues

Article 3 deals with the exemptions from the AIFMD. Among the issues considered by ESMA under this section are the calculation of the value of the assets under management, and what to do when the value of those assets occasionally exceeds or falls below the thresholds for authorisation.

Understandably, ESMA is more concerned by the value of the assets under management coming within the scope of the AIFMD than falling below the threshold for authorisation. In contrast to the latter situation (where ESMA takes the common-sense view that as it is possible for an alternative investment fund manager ("AIFM") to 'opt in' to regulation under the AIFMD, it should be for the AIFM to decide whether or not to notify the competent authority that assets under management are below the threshold), where the total value of assets exceeds the threshold, ESMA's advice is that the competent authority should be informed without delay; the AIFM can argue that the situation is temporary, but must provide supporting information for that view. In any event, if the value of the assets continues to exceed the threshold for a period in excess of three months, it cannot be considered as temporary and the manager will need to apply for authorisation under the AIFMD.

The value of assets under management should be calculated at least annually using the latest available net asset value calculation. This should include any assets acquired through leverage. Assets managed under the UCITS directive are not included. However, assets for which the AIFM would not require to be authorised in accordance with the transitional provisions in Article 61 of the AIFMD are included. At first sight this looks a little odd, but presumably ESMA takes the view that if these latter assets form the vast majority of the AIFM's assets under management, it would be open to the AIFM to restructure its business so that the transitional provision was still available (for instance, by forming a subsidiary to manage those assets) — which might also mean that the remaining assets under management fell under the threshold, so the AIFMD did not apply.

b. General operating conditions

ESMA's advice here covers the following elements:

- initial capital and own funds;
- general principles;
- conflicts of interest;
- risk management;
- liquidity management;
- investment in securitisation positions;
- organisational requirements;
- valuation; and
- delegation of AIFM functions.

Sensibly, ESMA has adopted the approach of aligning the draft advice so far as possible with the existing provisions in the UCITS Directive and MiFID, whilst recognising that alternative investment funds ("AIFs") are diverse and invested in different types of assets.

Initial capital and own funds

Under AIFMD Article 9(7), AIFMs are required to cover potential professional liability risks arising from professional negligence either by the holding of additional own funds or by professional indemnity insurance. ESMA was asked by the Commission to provide a description of the types of risks arising from professional negligence and the methods for calculating the respective amounts of additional own funds or the coverage of the professional indemnity insurance.

ESMA's description of the potential risks seems unobjectionable. The risks identified include risks in relation to the funds, in relation to investors, products and business practices (for example, negligent loss of documents of title, misrepresentations and misleading statements, and breaches of various obligations, such as those of confidentiality and those arising by operation of law or regulation), and in relation to systems failures. More controversially, perhaps, ESMA raises the question of whether it would be possible to include the improper valuation performed by a third party valuer within the risks to be covered, but as this is unlikely to involve professional negligence by the AIFM it seems unlikely that this would be feasible (as ESMA itself appears to recognise).

As far as the calculation of additional own funds is concerned, ESMA proposes a series of qualitative requirements (including effective internal operational risk management policies and procedures to identify, measure, manage and appropriately monitor operational risk, procedures for taking appropriate corrective action, and regular reviews) along with two options for quantitative requirements. Under Option 1, additional own funds to cover professional liability risks would be 0.01% of the value of AIF assets under management. Under Option 2, the percentage is reduced to 0.0015%, but with 2% of the 'relevant income' added. Relevant income is calculated as the sum of all income received in relation to the portfolio management activities of the AIFM (presumably in relation to AIFs only, though the text is not explicit on this point) less commission and fees, calculated on a three-year average. Competent authorities may adjust these figures downwards (for Option 1, from 0.01% to 0.008%; for Option 2, from 2% of relevant income to 1%) if the AIFM can demonstrate that liability risk is adequately captured by applying the lower figure.

For professional indemnity insurance, the minimum coverage per claim must be the higher of:

- 0.75% of the amount by which the value of the portfolios of the AIFM (again, though not explicit, this presumably means portfolios of AIFs only) exceeds €250 million, up to a maximum of €20 million; and
- €2 million.

The minimum aggregate coverage must be the higher of:

- 1% of the amount by which the value of the portfolios of the AIFM exceeds €250 million, up to a maximum of €25 million;
- €2.5 million; and
- the amount that would be required by way of additional own funds if the AIFM were using additional own funds rather than professional indemnity insurance.

General principles

ESMA's advice in this section covers various aspects that are familiar from the UCITS Directive and MiFID — for instance, due diligence requirements, reporting obligations, order handling, best execution, and the acceptance of inducements.

One interesting area covered by the advice concerns fair treatment by an AIFM. Here, ESMA asks for comment on two options: Under Option 1, fair treatment would require that no investor obtain a preferential treatment that has an overall material disadvantage to other investors. This would in effect define 'fair treatment' comprehensively. Under Option 2, fair treatment would include this aspect, but not be limited to it (that is, an AIFM could bring about the effect described, but need not thereby necessarily provide investors with fair treatment). ESMA seems to prefer the latter option; we will see whether respondents agree with this view.

Conflicts of interest

ESMA takes the view that AIFMs should be required to establish, implement and maintain a conflicts of interest policy. This is in line with the existing UCITS Directive and MiFID requirements, although ESMA has taken account of the fact that the AIFMD regulates the marketing to professional investors only. Thus, for example, a summarized description of the strategies for the exercise by the AIFM of voting rights is available to investors on request, rather than required to be provided to them (as would be the case under the UCITS Directive).

Risk management

ESMA recommends that the AIFM set quantitative and/or qualitative limits for all relevant risks, including market, credit, liquidity, counterparty and operational risks. ESMA does not, however, believe that it is appropriate for it to provide advice on which risks are more or less relevant for particular investment strategies. This seems a sensible approach, given that specifying the risks that should be covered depending on the strategies pursued could not only have been too inflexible but led to a “box ticking” approach without regard to the underlying risks of a particular business model.

Liquidity management

Given the diverse nature of the AIFMs within the scope of the AIFMD, ESMA’s advice in this area concentrates on general requirements rather than specific obligations. So AIFMs would be required to implement and maintain appropriate liquidity management arrangements and procedures, rather than be obliged to meet prescribed levels of liquidity. In keeping with this approach, AIFMs would be required to stress test their liquidity arrangements regularly, rather than to a set timetable (though it is expected that a stress test should take place at least annually).

Investment in securitisation positions

ESMA here follows the requirement derived from Article 122a of the Capital Requirements Directive that AIFMs should only invest in securitisations where the originator, sponsor, or original lender retains a net economic interest of at least 5%. However, there is no obligation on the AIFM to sell immediately if this retention provision is breached; the AIFM is required to take “corrective action” only (which could involve hedging the position as opposed to selling). This is both sensible as a matter of practicalities as well as helpful to AIFMs who invest in such positions.

Organisational requirements

This part of ESMA’s advice largely follows similar provisions in the UCITS Directive and MiFID. So an AIFM would be under a general requirement to establish, implement and maintain decision-making procedures and an appropriate organisational structure, and under specific obligations to have appropriate personnel resources, to maintain a permanent compliance and internal audit function, and to restrict personal account dealing by employees and other relevant persons.

Valuation

ESMA’s advice would require an AIFM to have written policies and procedures in place for the valuation of each AIF that it manages. If the AIFM uses an external valuer, Article 19(5) of the AIFMD requires the valuer to produce ‘sufficient professional guarantees to be able to perform effectively the valuation function’. Surprisingly, ESMA takes the view that this obligation cannot be satisfied by the valuer’s professional qualifications alone; but this is presumably on the basis that a general certificate of competence, even from a reputable professional body, does not mean that the valuer has the appropriate resources to carry out specific valuation tasks. If ESMA’s advice is followed by the Commission, one wonders whether over time a standard form will be developed (whether at the instigation of valuers or AIFMs) so as to reduce the potential volume of paperwork ESMA's advice could generate.

Delegation

The AIFMD allows an AIFM to delegate its functions to third parties, subject to certain conditions. One of these conditions is that the AIFM must be able to justify its entire delegation structure "on objective reasons" (Article 20(1)(a)).

ESMA's advice sets out two possible options for determining what "objective reasons" might be. Option 1 sets out a high-level principle: in order to comply with this provision, the AIFM should be able to demonstrate that the delegation is done for the purpose of a more efficient conduct of the AIFM's management of the AIF. Option 1 is based on the UCITS approach, and ESMA gives a number of examples in its explanatory text of what would fall within the category of a "more efficient conduct" of the management of the AIF: these include cost saving or the particular expertise of the delegate. Option 2 sets out a non-exhaustive list of objective reasons for delegating tasks. Since this list is, in effect, Option 1 plus the ESMA explanatory text, there is in practice little to choose between the two options.

II. Depositary

This section of ESMA's advice covers the appointment of the depositary (where ESMA lists the various elements to be covered in the agreement, although it does not provide a model agreement on the grounds that it would be impossible to cover all possible situations under the AIFMD), the duties of the depositary (including safekeeping, cash monitoring and segregation), and depositary liability. The last is a controversial area, as ESMA acknowledges, and it faces the difficult task of balancing the need for investor protection against the possible systemic risk that might result if the entire responsibility for loss were placed on the depositary.

ESMA proposes that a depositary should not be liable for the loss of instruments in its custody or the custody of a sub-custodian if all the following conditions are met:

- the loss did not result from the act or omission of the depositary or sub-custodian;
- the event leading to the loss was beyond the depositary's reasonable control (*e.g.*, act of God or acts of state); and
- despite rigorous and comprehensive due diligence, the depositary could not have prevented the loss.

Under Article 21(13) of the AIFMD, a depositary is allowed to "contract out" of liability in case of a loss of financial instruments held in custody by a third party (such as a sub-custodian) via a written contract with the AIF or the AIFM acting on behalf of the AIF, provided that there is an 'objective reason' for contracting such a discharge of liability. As elsewhere in its advice, ESMA gives two options as to what 'objective reasons' might mean. Under Option 1, the depositary is required to demonstrate that it had no option but to delegate (for example, as a result of legal constraints) or that it has agreed in writing with the AIF or AIFM that it is in the best interests of the AIF and its investors to delegate such duties (ESMA's example of such a circumstance is the delegate being in a country where the depositary does not operate). Under Option 2, a written contract with the AIF or AIFM under which it is agreed that the depositary can discharge its responsibility would in itself constitute the 'objective reason'. Although Option 2 is clearly easier to operate in practice, it is hard to believe that this is what the AIFMD text had in mind by an 'objective reason', and it will be interesting to see which option is eventually preferred.

III. Leverage and transparency requirements

One of the questions relating to the calculation of leverage relates to how the exposure of an AIF should be calculated. In general, ESMA believes that AIFMs should use a 'Gross Method' and 'Commitment Method' for the calculation of exposures, though it will be open to an AIFM to use an 'Advanced Method' on notification to its competent authorities, on the basis that this method is more appropriate for the strategies that the AIFM is using (for example, as regards hedging and netting arrangements). Although competent authorities are not required to give prior approval to the use of the Advanced Method (to avoid an unnecessary regulatory burden being placed upon them), they can request additional information from an AIFM which is proposing to use the Advanced Method, and presumably intervene to prevent use of the Advanced Method if they believe its use is unjustified.

ESMA also sets out the principles that in its opinion should govern when competent authorities will exercise their powers to impose leverage limits on AIFMs. ESMA has declined to advise on the appropriate timing of such regulatory intervention, on the grounds that this could fetter the regulatory judgment of competent authorities.

The section of ESMA's advice relating to transparency covers various aspects of the AIFMD that are designed to increase the information that is provided to investors and regulatory authorities:

- general principles and details relating to the annual report (including reporting material changes, the content and format of the balance sheet and the income and expenditure account, the content and format of activities for the financial year, and remuneration disclosure);
- disclosure to investors, including periodic disclosures of the risk profile of the AIF and regular disclosures of the maximum level of leverage wherever there is a material change; and
- disclosure to competent authorities, including quarterly reporting of the main types of investment in which the AIF is invested and the diversification of the portfolio, and whether leverage is being used "on a substantial basis" (where ESMA proposes the use of principles rather than a quantitative basis to determine this question, the principles including the type of AIF under management, the investment strategy of the AIFM, market conditions, and whether the degree of leverage employed by the AIF could contribute to the build-up of systemic risk in the financial system).

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The ESMA draft advice is a commendably detailed piece of work, which should ensure that the "Level 2" provisions that the Commission will adopt will be suitably comprehensive. It marks a significant step on the road to the implementation of the AIFMD.

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