

ESMA's final technical advice – the cornerstone for future AIFMD Level II Implementing Measures

Towards Level II rules

ESMA published its final technical advice on the Alternative Investment Fund Managers Directive detailed rules (Level II measures) on 16 November 2011. This largely technical paper brings further clarity to many fundamental issues in the Directive. Our briefing note evokes the major points of interest that are contained in ESMA's 500-page paper.

At present many in the industry have carried out a high level impact assessment on their business based on the text of the Directive, with considerable discussions on the pending Level II measures. Given the magnitude of comments made on the consultation paper, the final advice may well not be greeted by applause across the entire industry. However, whilst ESMA's technical advice is not the last step, it clearly brings more certainty on which decisions can be based and actions taken. The time is also right to consider any first mover advantage.

Scope – (gross) assets value

AIFMs with assets under management (AuM) in excess of €100m or €500m (unleveraged) are in scope of the Directive. ESMA slightly amended its advice on calculating the threshold.

The calculation is to be based on asset valuation and asset values must not be older than 12 months.

There is no single date for the minimum annual threshold calculation and no prescribed valuation methods, except for derivative positions.

Cross fund investments (same manager) and grandfathered funds are excluded from the calculation.



Temporary period for exceeding threshold remains at 3 months, thereafter application for authorisation is required.

Organisational requirements

ESMA proposes to require AIFMs to have additional own funds and/or professional indemnity insurance to cover risks arising from professional negligence. There is no cap on additional own funds. The general principles on organisation remain in line with MiFID and UCITS requirements. Many consultation respondents argued that the necessity for a permanent risk management function should be linked to proportionality, but finally all AIFMs will need to comply with this requirement. However ESMA allows for competent authorities to review and assess the functional and hierarchical separation of the risk management function in accordance with the principle of proportionality.

In relation to the proposals on liquidity management ESMA made no change to its initial proposals.

The valuation of assets is broadly in

line with the consultation paper but some clarifications are included in the technical advice, notably with regards to the consistent application of methodologies across AIFs managed by the manager, the review process of individual values and the minimum annual NAV calculation.

In terms of delegation the final text remains fairly consistent with the consultation paper, including the definition of a letter-box entity and a clarification that the letter-box provisions do not entail that an AIFM may not delegate its functions.

The general principles on delegation are in line with MiFID and UCITS, in particular regarding delegation to asset managers in third countries and the notion of regulation "equivalence" in relation to portfolio management and risk management has been deleted.

Transparency **Leverage calculation**

The two calculation methodologies of leverage (commitment and gross methods) are maintained with a

further option of calculating leverage using an advanced method on request by managers.

ESMA confirms that for AIFs whose core investment policy is to acquire control of non-listed companies or issuers, leverage in these portfolio assets should not be included in the AIF leverage calculation. However, leverage at the level of real estate funds holding structures will need to be included in the AIF leverage calculation.

Remuneration disclosure – minimal changes

While ESMA recognizes that those responsible for disclosures in the financial statements of the AIF may differ from the management of the AIFM, no additional practical advice is given.

Reporting to competent authorities – proportionate approach

Many will welcome ESMA's approach on reporting frequency which moved to annual, semi-annual or quarterly reporting based on total AuM, the size of the AIF itself or the investment strategy.

However, the 1-month deadline for reporting (funds of funds getting 1.5 months) and the substance of the reporting (see notably the proforma included as Annex V) have not changed. Reporting requirements are onerous and are likely to require a full integrated solution.

Depository functions

ESMA confirms that the depository's core functions of safekeeping and oversight are complemented by the requirement to properly monitor AIFs' cash flows. However in the final advice ESMA removed the requirement to open the general operating and subscription /redemption accounts at the depository.

In terms of safekeeping duties ESMA has made it clear that a look-through approach should be taken to assets held by financial/legal structures. ESMA also clarified that only collateral arrangements within the meaning of the Financial Collateral Directive should be taken into account for the purposes of defining whether financial instruments provided as collateral should be held in custody.

ESMA makes a distinction between custody and lighter record-keeping delegation requirements which apply

all along the custody chain and adds a requirement to notify the AIFM where the depository becomes aware that the segregation of assets becomes insufficient to ensure protection from insolvency of a sub-custodian.

ESMA also confirms the need for segregation with respect to "other assets" and specifically introduces the possibility to rely on legal opinions or accredited auditors with local expertise when carrying out the record-keeping duties.

ESMA maintains its view that the depository's oversight duty should include the valuation of underlying assets and not be limited to the valuation of the AIF units/shares. Also, the duties relating to the AIFM's instructions now refer to national law and regulation.

A very critical point is the liability of depositaries in case of loss of financial instruments. Not only is there a reverse burden of proof but losses resulting from fraudulent behaviour or operational failures are also in the scope of liabilities.

ESMA has moderated the language on "equivalence" for third country depositaries to regulation to have the "same effect". This allows the Commission to enter into a series of assessments of the outcomes of regulation in third countries and create a list of compliant countries by July 2013.

Supervision and third countries

ESMA has also reiterated its preference for a centralised approach to putting in place, as a high priority, an adequate supervisory framework with the negotiation of a Multilateral Memorandum of Understanding (MMoU) between ESMA (covering all EU competent authorities) and third country authorities, based on international standards.

ESMA agreed with suggestions to expand on the criteria to be taken into account when determining where the effective marketing of most of the AIFs takes place. The criteria could refer to the presence of distributors/affiliates rather than the number of investors which would change over time.

Next steps

The Commission will now prepare the Implementing Measures (Level II) based on ESMA's Advice.

Asset managers must now consider the implication of the advice on their business model. What may be the costs & benefits of having the AIFM or AIF in the EU or outside the EU and what are the organisational gaps? A lot of regulatory compliance needs to be dealt with and reliance on third parties for functions such as compliance or internal audit can be a valid and cost efficient alternative. Various players are already assessing and enhancing their systems and processes and reviewing which business partners can best support them.

The depository requirements

seriously impact the way some markets currently work, especially when the depository function for alternative assets does not exist. Luxembourg depositaries are not immune and will need to thoroughly review their operational and contractual framework and pursue the right business opportunities in areas such as reporting, data management, cash management, etc. In executing their duties they will also consider relying on proper systems, independent third party opinions and providers having a global service network to cope with various local laws and regulations.

Administrators and their clients will need to find the most efficient way to produce all the required reporting depending on the business frameworks in place. Some industries are used to reporting on returns and asset statistics but much less so on risk in investment language. Regulations such as AIFMD or Solvency II are introducing new rules in risk management which require more sophisticated portfolio risk evaluation and modeling techniques. Administrators will further be forced to look at their controls and processes and ensure they satisfy increased demands from clients and depositaries for transparency and evidence that operational frameworks are robust.

More reporting from Administrators will be expected.