

ESMA Consultation Paper on the Alternative Investment Fund Managers Directive

On 13 July 2011, the European Securities and Markets Authority ("ESMA") released its first draft technical advice on possible implementing measures in respect of the Alternative Investment Fund Managers Directive ("AIFMD"). This draft advice is the first step in the process of putting in place approximately one hundred level 2 implementing measures, technical standards and guidelines under the AIFMD. Although agreement was reached on the AIFMD in October 2010 and the final text published in the Official Journal on 1 July 2011, these implementing measures, technical standards and guidelines are needed to give concrete shape to the general provisions and principles set out in the AIFMD.

Scope and approach

The consultation paper covers an enormous amount of ground. It deals with implementing measures in respect of the working of the exemptions to the AIFMD, the authorisation requirements, the operating conditions, the depositary obligations and the requirements on transparency and leverage.

The approach taken by the ESMA consultation paper is based on:

- using UCITS and MiFID as the starting point where possible and maintaining an appropriate level of consistency with these directives. This is especially the case for the provisions on risk management, liquidity management, conduct of business rules and organisational requirements;
- taking into account the different types of Alternative Investment Funds ("AIFs") and the different types of assets in which they invest; and
- a proportional application of rules in light of the nature, scale and complexity of the business in question.

The implementing measures in respect of supervision, including the introduction of the passport for third party entities, will be covered by a separate consultation to be published later in the summer.

Background

AIFMD – The impact of the AIFMD cannot be underestimated:

- it is the first attempt at regulating the alternative investment management sector at a European level;
- it covers not only EU managers but also non-EU managers to the extent they manage AIFs established in the EU or market AIFs in the EU; and
- it covers a very wide range of fund products and structures.

ESMA - ESMA is the successor to CESR, the Committee of European Securities Regulators, and was created as part of the new supervisory framework for financial regulation in Europe that came into force in January 2011.

Whilst CESR prepared draft technical advice for the European Commission in the past and developed standards and guidelines which were addressed to its Members, under ESMA, a new dimension has been added to this role. ESMA will now be preparing draft laws rather than just technical advice. The role of the

Key Issues

Authorisation exemptions

General operating conditions

Depositaries

Limits to leverage

Disclosure to investors

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Commission in this case, will be to check that these draft laws are in the European Union's interest and are compatible with EU law and then to adopt these draft technical standards with minimal amendment, if at all possible.

Next steps

There are still opportunities for managers, depositaries, prime brokers and investors to engage with ESMA in response to the options and questions posed.

The consultation period closes on 13 September 2011, and ESMA intends to submit its advice to the Commission by 16 November 2011.

In the attached table we briefly set out some highlights of the consultation paper.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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| AIFMD rule | ESMA Proposal | Comment |
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| Authorisation exemptions – total AUM calculation and monitoring | | |
| <p>An AIFM will be exempt from authorisation under the AIFMD if it manages AIFs whose assets under management in total do not exceed a threshold of</p> <ul style="list-style-type: none"> • EUR 100 million; or • EUR 500 million for unleveraged AIFs. | <p><u>Parameters for AUM calculation</u></p> <p>(i) Scope - Assets to be excluded (subject to appropriate adjustments for leveraged exposure):</p> <ul style="list-style-type: none"> • UCITS in respect of which AIFM acts as management company; • investments in other AIFs managed by the same externally appointed AIFM; and • investments in another sub-fund of same AIF <p>But AIFs for which the AIFM is exempt under the transitional provisions (for example closed-ended type AIFs managed before 22 July 2013 but which do not make any additional investments after 22 July 2013) will need to be included.</p> <p>(ii) Annually – annual threshold calculation date to be fixed and changes to this date must be justified</p> <p>(iii) NAV - Latest available NAV calculation (to be produced within 12 months of the threshold calculation)</p> <p><u>Monitoring</u></p> <p>(i) procedures to monitor AUM on an on-going basis required;</p> <p>(ii) notification requirement to the regulator in case of threshold crossing; and</p> <p>(iii) authorisation required if crossing is not temporary (>3 months).</p> | <p>The option proposed by ESMA allows for a look-through approach whereby AUM will not be counted twice if managed by the same manager.</p> <p>The monitoring function does not provide for a requirement to do the calculation on a periodic basis, e.g. quarterly, but only on an on-going basis.</p> |
| Additional own funds or PII to cover professional liability risk | | |
| <p>In addition to the "own fund" requirements set out in the AIFMD, an AIFM must either have:</p> <p>(i) additional own funds which are appropriate to cover potential liability risks arising from professional negligence; or</p> <p>(ii) appropriate professional indemnity insurance.</p> | <p><u>Additional own funds</u></p> <p><i>Option 1</i> - equal to 0.01% of the value of AIF portfolios managed by the AIFM; or</p> <p><i>Option 2</i> - equal to 0.0015% of the value of AIF portfolios managed by the AIFM plus 2% of relevant income.</p> <p>It is possible for regulators to lower to 0.008% under Option (i) or lower the percentage of relevant income to 1% under Option (ii) if the AIFM can demonstrate on the basis of historical loss data that the liability risk would be adequately reflected. Regulators may also raise the own funds requirement if the liability risk is not sufficiently captured.</p> <p><u>Professional indemnity insurance</u></p> <p>Minimum coverage for each claim must be at least equal to the higher of the following amounts:</p> <p>(i) 0.75% of the amount by which the value of the portfolio exceeds EUR 250 million, up to a maximum of EUR 20 million; or</p> <p>(ii) EUR 2 million.</p> <p>Minimum coverage for claims in aggregate per year must at least equal the maximum of the following amounts:</p> <p>(i) 1% of the amount by which the value of the portfolios exceeds EUR 250 million, up to a maximum of EUR 25 million;</p> <p>(ii) EUR 2.5 million; or</p> <p>(iii) the additional own funds requirement for the AIFM.</p> | <p>Option 1 is based on an existing method for the calculation of additional own funds. It is already implied in Article 9(3) of the AIFMD (and in Article 7(1)(a)(i) of the UCITS Directive).</p> <p>Option 2 takes into account variable income. This component will be significant to small AIFM with higher income figures, which may be an indication to their regulators of higher levels of risks being taken.</p> |

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| Liquidity management | | |
| <p>An AIFM shall regularly conduct stress tests under normal and exceptional liquidity conditions.</p> <p>Alignment required of investment strategy, liquidity profile and redemption policy.</p> | <p><u>Parameters for stress tests</u></p> <p>The stress tests shall:</p> <ul style="list-style-type: none"> (i) be conducted on the basis of reliable and up-to-date information in quantitative terms or, where this is not appropriate, in qualitative terms; (ii) where appropriate, simulate a shortage of the liquidity of the assets in the AIF as well as atypical redemption requests; (iii) cover market risks and any resulting impact, including on margin calls, on collateral requirements or credit lines; (iv) account for valuation sensitivities under stressed conditions; and (v) be conducted at a frequency which is appropriate to the nature of the AIF, taking in to account the investment strategy, liquidity profile, type of investor and redemption policy of the AIF, but, at a minimum, annually. <p><u>Alignment of investment strategy, liquidity profile and redemption policy</u></p> <p>Investment strategy, liquidity profile and redemption policy will be considered to be aligned when investors have the ability to redeem their investments:</p> <ul style="list-style-type: none"> • in a manner consistent with the fair treatment of all AIF investors; and • in accordance with the AIF redemption policy and its obligations. <p>AIFMs should have regard to the impact that redemptions may have on the underlying prices and/or spreads of the individual assets of the AIF.</p> | |
| Organisational requirements | | |
| <p>An AIFM needs to use at all times adequate and appropriate human and technical resources that are necessary for the proper management of AIFs.</p> | <p><u>Compliance function</u></p> <p>Permanent and effective compliance function to be established and maintained, which operates independently.</p> <p><u>Audit function</u></p> <p>Permanent internal audit function to be established and maintained, which operates separately and independently.</p> | <p>The requirements to have effective compliance and internal audit functions applies irrespective of size and complexity of the business. ESMA seems to allow for exceptions to independence and separation if disproportionate due to size of AIFM or nature, scale and complexity of business.</p> |
| Delegation | | |
| <p>An AIFM cannot delegate to the extent that it can no longer be considered to be the manager of the AIF and has instead become a letter-box entity.</p> | <p>The AIFM would become a letter-box entity and could no longer be considered to be the manager of the AIF where:</p> <ul style="list-style-type: none"> (i) the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation; or (ii) the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of senior management or no longer has the power to perform senior management functions, in particular in relation to implementation of the general investment policy and investment strategies. | <p>Letter-box limit is also provided for under UCITS but is not further defined in UCITS Level 2.</p> |

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| Depository | | |
| <p>The depository shall in general ensure that the AIF's cash flows are properly monitored</p> | <p>Two options are provided in respect of monitoring of all AIF's cash flows:</p> <p><u>Option 1</u> - the depository would be considered 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. To enable the depository to achieve that objective, option 1 includes a requirement for the instructions related to the third party cash accounts to be sent simultaneously (from the AIFM or the third party entity) to the depository. As a consequence, the depository could intervene immediately if it considers the cash flows inappropriate.</p> <p><u>Option 2</u> - the depository's obligations would consist in verifying that there are procedures in place to monitor the AIF's cash flows and that they are effectively implemented and periodically reviewed. Those procedures could be internal to the depository where the cash accounts are opened at the depository or could be performed by the AIFM itself, its accountant / administrator or another service provider.</p> | <p>First option definitely more cumbersome and might cause potential delays for investment process.</p> |
| <p>The depository shall be liable for the loss by the depository, or a third party to whom the custody of financial instruments held in custody has been delegated.</p> | <p><u>Financial instruments held in custody & collateral</u></p> <p>ESMA proposes three options as to when financial instruments provided as collateral should not be held in custody:</p> <p>(i) they are provided under a title transfer financial collateral arrangement; or</p> <p>(ii) they are provided under a title transfer financial collateral arrangement or security financial collateral arrangement by which control over/possession of the financial instruments is transferred away from the AIF or depository; or</p> <p>(iii) they are provided under a financial collateral arrangement.</p> <p><u>Loss</u></p> <p>Three conditions under which financial instruments should be considered 'lost':</p> <p>(i) financial instruments no longer exist or never did (which will typically cover accounting error and fraud situations);</p> <p>(ii) financial instruments exist but the AIF has lost its right of ownership over them; and</p> <p>(iii) AIF still holds the ownership right but cannot dispose of the financial instruments.</p> | <p>Financial instruments will only be considered "lost" if they are permanently unavailable. The situation where financial instruments are merely held-up or frozen would not fall under the definition of "loss". The consultation document helpfully sets out that in most cases of insolvency of a sub-custodian, "loss" of financial instruments will only take place at the end of the insolvency proceedings.</p> |
| <p>The depository shall not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.</p> | <p>Three stage test under which the burden of proof is on the depository to establish that:</p> <p>(i) event which led to the loss did not occur as a result of an act or omission of the depository, or one of its sub-custodians, to meet its obligations;</p> <p>(ii) the event which led to the loss was beyond its reasonable control; and</p> <p>(iii) despite rigorous and comprehensive due diligence, it could not have prevented the loss.</p> | <p>ESMA states that on the insolvency of a sub-custodian, loss caused by the sub-custodian's failure to implement the segregation rules or as a result of disruption in relation to its default should be deemed caused by an internal event. The three stage test seems rather onerous and the last leg requires clarification.</p> |

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| Powers to impose leverage limits or other restrictions | | |
| <p>The regulators of the home Member State of the AIFM can impose limits to the level of leverage that an AIFM is entitled to employ or other restrictions on the management of the AIF with respect to the AIFs under its management 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.</p> | <p><u>Proposed principles</u></p> <p>Principles 1-3 set out the framework under which regulators should consider the use of leverage by AIFM.</p> <p>Principle 4 sets out illustrative (i.e. not exhaustive) circumstances, criteria and likely possible scenarios which should guide a regulator's assessment and judgement whether or not intervention in respect of leverage in a particular AIF is appropriate:</p> <p>Suggested circumstances:</p> <p>(i) leverage constitutes important source of market, liquidity, or counterparty risk to a financial institution, in particular, to systemically relevant institutions;</p> <p>(ii) leverage may contribute to the downward spiral in the prices of financial instruments, or other assets, in a manner which threatens the viability of such financial instruments or other assets;</p> <p>Suggested criteria:</p> <p>(i) the type of AIF, the AIFM's investment strategy, the market conditions in which the AIFM and the AIF operate, and any likely pro-cyclical effects which may result from the imposition by the regulators of limits or other restrictions;</p> <p>(ii) the size of an AIF or group of AIFs and any related impact in a particular market sector, any concentration of risks in particular markets in which an AIF or group of AIFs are invested, any contagion risk to other markets from a market where risks have been identified, any liquidity issues in particular market or sector at a given time, the scale of any asset/liability mismatch in a particular AIFM investment strategy, or any irregular evolution of prices of assets in which an AIF may be invested.</p> <p><u>Timing</u></p> <p>Appropriate timing for applying the measures should be determined having regard to the need to avoid or minimise any identified risks, including systemic risk. Timing of any such measures shall take into account the nature of the risk and degree of any likely impact on the stability and integrity of the financial system.</p> | <p>Is unclear whether or not any leverage limits would apply only in respect of an AIF or also in respect of the subsidiaries of the AIF.</p> <p>ESMA took the view that it was not appropriate to set any strict or pre-determined timeframes or rules on the precise timing of any supervisory intervention</p> |
| Periodic disclosure to investors | | |
| <p>AIFM shall periodically disclose to investors:</p> <p>(i) the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature;</p> <p>(ii) any new arrangements for managing the liquidity of the AIF; and</p> <p>(iii) the current risk profile of the AIF and the risk management systems employed by the AIFM to manage these risks.</p> | <p><u>Special arrangement</u></p> <p>A special arrangement is defined as "<i>an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impact the specific redemption rights of investors in a class of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors.</i>"</p> <p><u>New arrangements for managing the liquidity of the AIF</u></p> <p>AIFMs should immediately notify investors where they activate gates, side pockets or similar special arrangements or where they decide to suspend redemptions, and the disclosure should contain an overview of the changes made and whether any special or other arrangements apply. Additional disclosure obligations would be triggered where there are 'material changes'.</p> <p><u>Risk profile of the AIF</u></p> <p>ESMA have advised that AIFMs should periodically disclose the current risk profile of each AIF and have proposed two options for AIFMs: one provides AIFMs discretion to determine appropriate disclosures whereas the other is more prescriptive</p> | <p>ESMA considers suspension is not covered by the definition.</p> |