

# *ESMA publishes final advice*

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*ESMA issues final advice  
on Level 2 measures – some  
more answers, some more  
questions.*





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## Introduction

*On 16 November, the European Securities and Markets Authority (ESMA) published its final advice (the Final Advice) to the European Commission (the Commission) on possible implementing measures (also known as the Level 2 measures) under the Alternative Investment Fund Managers Directive (AIFMD or the Directive).*

The report containing the Final Advice followed the two consultations that took place over the summer and early autumn (the CPs) – see *AIFMD Newsbrief 9*.

PwC<sup>1</sup> has continued to work intensively across Europe with clients (both individual firms and trade bodies) evaluating the impact of AIFMD across the asset management sector and in analysing the provisions of the Final Advice.

However, the Final Advice remains just that – advice – and, given the “post Lisbon” changes to the European political decision making process, the Commission will still be able to introduce amendments in those areas where it has particularly strong views. We are aware that the Commission is already canvassing industry on certain areas where it apparently is not entirely happy with the position taken by ESMA.

Notwithstanding this risk, the industry now has a clearer picture of what the full AIFMD regulatory framework will mean for it and we expect that substantial proportions of the Final Advice will pass through without significant changes. However, on a number of key issues, unsatisfactory and unaddressed positions remain, meaning it is even more important for the industry to continue to engage in dialogue with the Commission until the final measures are adopted in spring 2012.

The objective of this Newsbrief is to update you on some of the issues that we covered in our last Newsbrief, and to take a look at the “bigger picture” now that further details have emerged.

In our view, these details have the potential to cause the most concern, and therefore cannot be ignored by industry – asset managers and service providers alike – when it comes to preparing for AIFMD.

1. “PwC” refers to the network of member firms of PricewaterhouseCoopers International Limited, or, as the context requires, individual member firms of the PwC network.

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## *Timetable and political process*

The consultation periods for the CPs closed in September, leaving ESMA with the substantial task of having to review, distil and interpret over 100 responses to formulate its Final Advice to the Commission.

Since receiving the Final Advice, the Commission has reached out to stakeholders seeking both technical and substantive comment. While the Commission is not obliged to accept this Final Advice, we expect the majority to be adopted, particularly around operational and reporting requirements, but we believe there is some risk that in the areas of depositary obligations, treatment of collateral and third countries some further movement may occur. We expect this process of informal consultation to continue until early in the New Year. Thereafter, we expect that the Commission will send its finalised draft measures (incorporating those sections of the Final Advice that it is minded to adopt) to the Council and European Parliament in March 2012. Both Council and Parliament will have three months to review the draft measures, meaning the Commission is likely to formally adopt the final implementing measures in July 2012.

From a legislative process perspective, the Commission has not yet addressed the important issue of whether or not the Level 2 measures will primarily take the form of Regulations (which are automatically binding on EU Member States) or

Directives. Directives have to be implemented by each of the EU Member States and this can lead to untimely implementation and different interpretations when they are introduced into national regimes. On the other hand, it does preserve Member State discretion to have regard to its own legal frameworks, against which Regulations can fit very awkwardly.

After the Commission has adopted the Level 2 measures, ESMA will supplement those implementing measures with technical standards and guidance, which can only be finalised once the implementing measures are enacted.

Regardless of the remaining uncertainties and the legislative steps still to come, managers (AIFMs) of alternative investment funds (AIFs) and service providers should take action now to review and assess the impact of the Final Advice on their businesses before the measures are finalised. The next few months represent the last real opportunity to lobby for meaningful changes on any remaining areas of concern that you believe will adversely affect your business.

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## *The Final Advice – Summary*

At over 500 pages, the Final Advice does not make for easy reading, not least because many provisions on which the industry lobbied heavily remain unchanged, such as the calculation basis for the regulatory capital regime, which follows a regime more suitable to the banking sector. However, in some areas ESMA has listened to the responses to the CPs. For example, ESMA has made some positive changes on the third country front, having grasped the risks posed by the proposed “equivalence” standard.

Below we discuss these areas in more detail, summarise relevant key issues and update comments made in our last Newsbrief<sup>2</sup>.

The Final Advice follows the structure of the CPs and can be split into 5 main categories (although ESMA combines leverage and transparency into one section):

1. General operating conditions, including valuation, risk and liquidity management and organisational conditions
2. Depositary requirements
3. Implementing measures on leverage calculation
4. Transparency requirements
5. Third countries

2. This briefing is necessarily a summary and does not cover every issue raised in the Final Advice, which AIFMs and service providers should review in its entirety and seek further advice on specific areas of concern.

# 1. General operating conditions

## Scope

As expected, the Final Advice does not touch upon the scope of AIFMD because the Commission did not include this topic in its mandate to ESMA. At first glance, the definitions of an AIFM and an AIF in the Directive seem straightforward, but because of the diversity of entities and products within the EU, applying these definitions is far more complex. ESMA is fully aware of these issues and, to the extent that the individual Member State regulators do not deal with this issue, ESMA will hopefully address this in the technical standards it is also due to produce.

## Exemptions

The Directive establishes de minimis thresholds, as well as the possibility for small exempted firms to opt into the regime if they wish. However, this approach creates uncertainties as to the treatment of those firms that cross the threshold at some point in time (either up or down).

The CPs proposed various methods for calculating assets under management (AUM) to assess whether either of the de minimis threshold exemptions should apply and considered how frequently AIFM should carry out these calculations. Firms that cross the threshold must inform their competent authority “without delay” and confirm whether or not they consider the breach to be temporary. “Temporary” is defined as a time period not exceeding three months. At the end of that period, AIFMs will be obliged to recalculate their AUM to confirm that they have fallen back under the threshold.

The Final Advice took on board the numerous arguments against its recommendations to use net asset value as the basis for calculating AUM in this context, which many felt was not the most appropriate basis. In a welcome amendment, ESMA reconsidered its position and has recommended that generally the aggregate AUM calculation should be performed at least annually using the latest asset value calculations.

The Final Advice further specifies that in calculating the aggregate AUM, derivative instruments should be converted to an equivalent position in the underlying asset (rather than including their market value). However, derivatives used for hedging purposes can be excluded. This could result in a significant number of AIFMs being caught by the Directive even if their net asset values NAVs are below the thresholds.

In addition, ESMA has confirmed the following matters introduced in the CPs:

- AIFMs will be required to monitor the value of aggregate AUM on an on-going basis
- As mentioned earlier, the arrangements as regards temporary threshold breaches
- AIFMs will be allowed to exclude investments by AIFs in other AIFs under management from the aggregate AUM calculation.

### **General operating principles and processes**

Generally, the Final Advice has not moved significantly beyond the recommendations in the CPs, which given ESMA's general endorsement of MiFID and UCITS principles is unsurprising. AIFMs which are not already subject to these regimes which impose rigorous operating requirements will need to materially upgrade their systems and controls. Even firms fully regulated by their Member State regulators within these regimes may need to improve their infrastructure materially in areas like identifying and managing conflicts of interest, and liquidity and risk management.

The new regulatory capital requirements or "own funds" required to be maintained by AIFMs are still an area of contention, although ESMA sought to respond to a number of criticisms in this area. ESMA acknowledged that many respondents to the CPs expressed a general concern about additional own funds and the professional indemnity insurance requirements, both as to absolute quantum and to the amount being correlated to AUM. Respondents highlighted that additional own funds rules would be inappropriate for internally managed AIFs. They also noted that the type of insurance cover described by the CPs (e.g. without any exclusions and covering liabilities over which the insured would have no control) would be virtually impossible to purchase.

Addressing these concerns, ESMA responded by introducing the possibility of having a combination of additional own funds and professional indemnity insurance and clarifying that while coverage was to remain broad, a more practical description of risks to be covered would be acceptable. However, ESMA did not take on board the request to introduce

a cap for the additional own funds required by Level 1 because this change would have put larger AIFMs at a competitive advantage - another welcome example of ESMA taking into account the diversity of AIFM needs.

### **Risk and liquidity management and compliance**

The Final Advice does not depart significantly from the CPs in these areas. ESMA recommends that each AIFM creates a functionally and hierarchically separate risk management function and formally documents a risk management policy relevant to the specific dynamics of each AIF it manages, following provisions analogous to those contained in recent UCITS requirements.

That said, ESMA acknowledged the frustrations expressed by a number of respondents to the CPs who stressed that it may be difficult for some AIFMs to meet the requirements on functional and hierarchical separation, particularly for small AIFMs and private equity and venture capital managers. ESMA believes that the competent authorities reviewing the functional and hierarchical separation of the risk management function should apply the principle of proportionality, taking into account the operational structure of the AIFM and its corporate governance arrangements. ESMA believes this should result in a proportional and fair approach regarding these smaller types of AIFMs and AIFs.

On liquidity, ESMA re-iterated its concerns that failures in adequate liquidity management had exacerbated the 2008 financial crisis. It was unsympathetic to those respondents who commented on the requirement for fund of hedge fund managers investing in underlying AIFs to monitor those AIFs' approach to liquidity management. ESMA stated that it was not convinced by this argument

and strongly believes that AIFMs should carry out specific due diligence in relation to the liquidity of the underlying AIFs, including monitoring their liquidity profile.

ESMA also recognised that some respondents felt that the Final Advice was not sufficiently tailored to take into account the diversity of AIFs in the market. ESMA has responded by setting out fundamental general requirements for all AIFMs which can be adapted to the diverse size and structure of the AIFM and to the nature of the AIF under management.

On conflicts of interest, ESMA has not significantly departed from the CPs. An AIFM will be required to establish, implement and maintain an effective conflicts of interest policy. In our last Newsbrief, we commented on some of the practical difficulties that will arise from these requirements for AIFMs and which readers would be well-advised to revisit.

ESMA has also maintained its stance on compliance functions generally - an AIFM will be required to create a permanent compliance function (which it can outsource) and to demonstrate that internal management, control, decision-making procedures and supervision processes are appropriate for the AIFs under management.

### **Valuation**

The Final Advice does not contain any noteworthy changes on valuation requirements and procedures. Overall, the industry has welcomed ESMA's possible implementing measures on valuation, which provide for a robust framework adaptable to the specific characteristics of the diverse types of assets in which AIFs can invest.

The Final Advice has provided some useful clarifications:

- The valuation of the AIF's assets can be performed by one or several external valuer(s) or the AIFM. The AIFM's potential liability in case of improper valuation is unaffected by the appointment of an external valuer.
- Pricing vendors are not considered external valuers.
- The fund administrator performing the net asset value calculation would not be considered the external valuer, as defined by the Directive, as long as the administrator only incorporates values provided by pricing sources, the AIFM or external valuer(s).
- For open ended funds, the valuation of financial instruments must be carried out each time a net asset value is calculated. The valuation of other assets (such as real estate or non listed companies) must be carried out at least annually unless the last determined value is no longer considered fair or proper.

For closed ended funds, the Directive indicates that the valuation is to be carried out at least annually and in case of an increase or decrease in capital. ESMA does not provide any additional guidance in its Final Advice. The industry could argue that, in practice, only the issue of (or subscription for) units of closed-ended funds takes place at the point of acceptance by the AIFM of the commitment by the proposed investor to the AIF.

ESMA's Final Advice has still not addressed the governance role and responsibilities of AIFs and their governing bodies in valuation.

## 2. Depositary requirements

ESMA has moved forward significantly on depositary requirements, which were the most heavily commented on (and in some quarters, criticised) aspects of the Directive and the Level 2 measures contained in the CPs.

However, most respondents (but by no means all) have supported the approach of taking the UCITS requirements as a benchmark, with adaptation to the AIFM sector where relevant, as well as for the decision not to develop a model agreement.

In general, where ESMA outlined several policy choices in the CPs, it has generally selected the less costly and onerous option. However, even the less onerous choice is likely to represent a considerable incremental burden on depositaries, AIFMs and ultimately investors, through increased compliance costs.

The Final Advice no longer includes requirements for AIFMs to mirror all cash held with third party custodians and other assets in their own records and has confined transaction monitoring to “ex post” checking rather than “ex-ante” approval.

ESMA has included clearer definitions of “loss” and of the safekeeping duties in relation to the custody duties of a depositary and appears to have followed the majority of industry recommendations in directing the Commission towards preferred options regarding the definition of a “financial instrument” held in custody, the depositary’s safekeeping duties over other assets and the treatment of collateral.

However, ESMA has ignored some respondents preferred option of setting out of duties related to timely settlement of transactions and what should constitute objective reasons for the depositary being viewed as having discharged its contractual duties.

These developments aside, many depositaries’ key concerns have not been addressed and remain in substance identical to those foreseen in the CPs. For example, ESMA has not changed the sub-custodian liability provisions. Custodians will still be liable for sub-custodians’ losses of assets, both for affiliated sub-custodians (which industry reluctantly conceded might be feasible) and also for non-affiliated sub-custodians, which represents a substantial operational and risk challenge. The Directive provides an exclusion from such liability for external events beyond reasonable control, but the definition of external event remains particularly narrow.

Two other particular points of concern remain:

- If a sub-custodian becomes insolvent, the event would only be considered external if the law of the relevant country does not recognise the effect of segregation. All other losses associated with insolvency are considered internal.
- Liability in case of fraudulent behaviour (despite strong due diligence processes) may not be considered an external event.

### 3. Leverage

In its Final Advice, ESMA did not significantly change the general provisions on calculating an AIF's exposure. Both the gross and commitment methods remain mandatory, notwithstanding that, as respondents pointed out, the gross method will produce unfamiliar and potentially materially misleading numbers. In addition, the advanced method is allowed, upon notification, when the commitment method is not considered appropriate or meaningful. The commitment method, which allows netting and hedging arrangements, received more support although some respondents called for relaxing the restrictive rules applicable to these arrangements.

Many respondents saw the merit of the advanced method but would have preferred using Value at Risk. However, ESMA's Final Advice reconfirms its view that the information on the level of gross leverage is of the utmost importance in the context of the monitoring of systemic risk and that this information should be disclosed to investors.

ESMA has recommended that because many AIFMs manage UCITS-like AIFs, the rules applicable to netting and hedging arrangements should be aligned to the UCITS rules.

ESMA has also significantly increased the detailed guidance on how to calculate leverage under both the gross and commitment approach. We expect ESMA to provide additional guidance on the advanced method, most likely in the form of a technical standard.

Finally, ESMA provided clarification on how to account for leverage at the level of financial or legal structures. The Final Advice specifies that the AIFM should 'look through' these structures when calculating its exposure, to the extent those structures have recourse to the AIF via cross collateralisation or guarantees.

## 4. Transparency requirements

The Final Advice has addressed the frequency of reporting to Member State regulators - one of the key concerns on transparency requirements.

Although initially quarterly reporting was proposed, the reporting to Member State regulators is now based on a frequency varying according to the level of AUM. Only AIFM with AUM greater than €1.5 billion or with individual funds with AUM in excess of €500 million will be required to report on a quarterly basis. However, where AIFM market / manage unleveraged funds with controlling interests in non listed companies, they need only report on an annual basis. Reporting to Member State regulators will include both qualitative and quantitative information with extended disclosures for funds using leverage on a substantial basis and for funds with controlling interests in non listed companies. The appendix of the Final Advice sets out the expected content and a pro forma template. The detailed content of the annual report, reporting to investors and regulators remains largely unchanged compared to the CPs.

ESMA's Final Advice provides detailed guidelines on the content and format of the information to be provided in three main categories:

- Annual report, including remuneration disclosure
- Disclosures to investors, before they invest and on a regular basis
- Reporting to competent authorities.

While the annual report content requirements closely follow existing international practice, both the Directive and the Final Advice fail to recognise the role of the senior governing bodies of AIF in preparing annual audited statements.

On remuneration disclosure, it seems likely that, perversely, the rules would be most prejudicial to small AIFMs who would not be able to avoid disclosing detailed and personal information - unlike larger AIFMs who would be able to take advantage of options and make disclosures much less specific to individuals. It is also not clear that ESMA's primary objectives on remuneration disclosure will be met. Many AIFMs subject to the Directive will delegate the risk taking activities. Thus, the remuneration associated with these activities will not reside within the AIFM and, as a result, will be not be subject to disclosure in the AIF's annual report.

Third country AIFMs who market their funds in the EU will need to submit reports to each Member State regulator where the AIF are marketed.

Under the Directive, third country AIFMs who market their third country AIF through private placements in the EU will be required to comply with all transparency requirements from 2013. Such AIFMs are concerned that they will effectively be subject to substantive compliance with other operational sections of the Directive (such as remuneration, risk and liquidity management and leverage). ESMA's Final Advice does not foresee any type of disclosure carve-out for third country AIFMs, aside from the results of risk and liquidity management stress tests.

Many in the industry feel that the transparency requirements are too onerous and not adapted to the various types of AIFs in scope. Compliance will require significant set-up and ongoing costs, especially for those reporting to the Member State regulators on a quarterly basis.

## 5. Third countries

The so-called Third Country situation is addressed in various sections of the Final Advice, although it had originally been dealt with in a stand-alone consultation paper where the position of third countries was split into the following four areas:

- Delegation of portfolio or risk management to third country undertakings
- Appointment of a depositary based in a third country
- Co-operation arrangements between EU and third country competent authorities in connection with the management and marketing of third country (or third country managed) AIFs
- Determination of the Member State of reference.

In the first two areas, the CPs had re-introduced the concept of equivalence which had been negotiated out of the Level 1 text. For third country depositaries to be eligible to act for AIFMD compliant AIFs, the CPs required them to be subject to a regulatory regime equivalent to that proposed for EU depositaries under AIFMD (which arguably went beyond the requirements of Article 21 in the Directive). For the delegation of portfolio management and / or risk management, the third country delegate was to be authorised or registered for the purpose of asset management based on local criteria which are equivalent to those established under EU legislation.

In light of the overwhelming consensus that ESMA had overstepped the mark in re-introducing this standard, the formal requirement for equivalence has been dropped in the Final Advice.

For depositaries, however, the hurdles remain very high, as not only must third country depositaries be subject to prudential and operating requirements having the same effect (as foreseen in Level 1) as relative EU legislation, they must also be subject directly to regulations having the same effect as Article 21(7) to (15) of AIFMD – namely the provisions which create the uniquely rigorous duties for depositaries of AIF of supervision, oversight and liability to investors for lost assets – which has created such industry criticism. The effect of this language may well mean that third country entities will not, unless the jurisdictions in which they operate make a positive determination to adopt an EU depositary operating and liability model (or unless they accept these duties and related liability contractually), be eligible to act as principal depositaries for AIFMD compliant funds (although they will be able to act as sub-custodians).

For the delegation of portfolio management and/or risk management to third country entities, the precondition that such entities, to be eligible for delegation, must be subject to regulations ‘which are equivalent to those established under EU legislation’ has also been amended, with the requirements now being that firstly, there be in place written co-operation agreements between relevant EU member state regulators, ESMA and the relevant overseas regulator to allow the EU regulators to perform their supervisory duties; and secondly, that the delegate be appropriately authorised and supervised in its home jurisdiction.

In the third area, the Final Advice provides some guidance as to the form and content of the cooperation arrangements to be implemented, but avoids stipulating the detailed format or content of these agreements, only indicating that the detailed format will be issued by the time Level 2 measures are finalised, which is unlikely to be before next summer. ESMA is also proposing that the required Multilateral Memoranda of Understanding (MMoUs) be centrally negotiated by ESMA in order to limit regulatory arbitrage.

In view of the Final Advice that the MMoUs contain provisions which will oblige third country regulators to allow EU regulators the power to supervise third country firms in accordance with the Directive, the negotiation of these agreements may prove contentious, which is a potential threat to the continued access to EU investors for those AIFMs proposing to rely upon the private placement regime “safe harbour” built into the Level 1 text.

As a reminder, while third country AIFMs will be able to continue to market their managed funds (whether established off-shore or within the EU) via national private placement regimes until 2018, they will be required as soon as 2013 to comply with the transparency requirements (annual report, information to investors and regulators) of the Directive and, if they are in the private equity space, the notification and disclosure requirements arising in connection with the acquisition of controlling interests non listed EU companies.

The MMoUs mentioned above between the regulator of the AIFM and each EU country where the AIFs are marketed

and between the regulator of the AIFM and the regulator of the domicile of its EU AIFs (when applicable) will need to be in place. If these are not in place, notwithstanding compliance by AIFMs with those requirements under their control, access to EU markets for their AIFs will be limited to access by “passive marketing”, even if the AIFs are EU domiciled.

Lastly, regarding item four, ESMA continues to believe that, in case of conflict between several Member States, the Member State of reference should be identified taking into account the Member State in which the AIFM intends to develop effective marketing for most of its AIFs.

## *PwC's response*

Despite the publication of the Final Advice, the industry continues to face a number of key practical issues:

1. The continuing lack of clarity remains a concern – some firms still say they are finding it hard to properly get to grips with AIFMD because of the lack of detail. They do not feel able to clearly evaluate the impact on their business model and markets.
2. Timelines are challenging: with the Level 2 rules not enacted until July 2012 and national transposition measures unlikely to emerge until the summer of 2012, the lead time to get ready is going to be tight.
3. The remuneration requirements imposed on AIFM means only the smallest asset manager will avoid the full rigour of the detailed rules potentially.
4. Who is really responsible for the AIF's activities: concerns remain that the changing rules on who is really responsible for governance of an AIF will alter where central management and control is for tax purposes, thereby possibly upsetting carefully thought through tax planning.
5. For service providers a gap is opening up between depositaries and prime brokers: depositaries are concerned about costs, liability and a whole catalogue of new responsibilities and how these will feed through in terms of costs of capital, systems etc. The prime brokers want to preserve their business models as far as possible and avoid picking up any depositary liabilities. As a result, depositaries are fighting on two fronts - with ESMA and the Commission in an attempt to mitigate the most severe consequences of liability rules and to clarify what they will be strictly responsible for on the one hand, and on the other, with the prime brokers on the other, trying to get them to pick up some of the risks.
6. Respondents felt that the consultation paper on third countries was poorly drafted. In the Final Advice, perhaps some of these concerns are alleviated with the removal of some equivalence requirements, although a number of unsatisfactory areas remain.

We have seen a relative lack of engagement by many asset managers and service providers. Up until now, some have taken the view that it is premature to engage with AIFMD (other than at a high level) because of the lack of clarity around how the detail will work.

We recognise that AIFMs face many more immediate concerns, ranging from coping with macro-economic events, adapting to new investor demands on a day to day basis, and dealing with more immediate regulatory measures (e.g. FATCA and investment advisor registration under Dodd-Frank). However, putting AIFMD on the back burner for much longer is not an option. Service providers and administrators should have started planning their responses already – they will be the first ports of call for managers seeking solutions. For larger managers with international operations, the impact and gap analysis work should be getting underway. For managers with less complex business models and product ranges, waiting for the Commission's technical standards may be an option, but by Q2 2012 all AIFM should be starting preparation for implementation.

The Final Advice provides much more definition in some key areas and, notwithstanding continued lack of clarity in some other areas, we recommend AIFMs and service providers begin performing preliminary impact analyses to position themselves for timely compliance with AIFMD.

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