

SECURITIES AND MARKETS STAKEHOLDER GROUP

Advice on ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive in relation to supervision and third countries

I. EXECUTIVE SUMMARY

The Securities and Markets Stakeholders Group has reviewed ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive. This advice distils an impressive amount of work conducted within a compressed timeframe, for which ESMA deserves compliments.

In our analysis of the draft ESMA advice, we have focused on how it contributes to achieving the main purposes of the AIFM directive: anticipate systemic risk and provide the appropriate level of investor protection. The Stakeholder Group has considered if these objectives are achieved in a fit for purpose manner, wherever possible minimizing market impact. This should also allow the right level of tailoring and proportionality for the fundamental diversity and divergence in nature, scale and complexity of the different product offerings to those investors whilst also offering them the protection provided by the AIFM directive.

In this perspective, the Stakeholder Group would like to acknowledge the highly valuable work of ESMA and supports its overall approach of the AIFMD, but also calls for a consideration of a number of specific elements of the draft ESMA advice. Consideration by ESMA should lead to a better balance between market stability and investor protection on the one hand and proportionality and diversity of investment opportunities offered to European investors on the other hand. Currently there are some elements in the Draft Advice that could potentially impact this balance, in particular where certain proposals can appear not to be strictly aligned with the purposes of the AIFM directive, such as more specifically the proposals around (i) the use of equivalence for third country purposes and (ii) the operating conditions regarding risk management, due diligence or internal organizational requirements for managers.

II. INTRODUCTION

1. The Securities and Markets Stakeholders Group welcomes this opportunity to comment on the European Securities and Markets Authority's ("ESMA's") consultation papers on its draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (the "AIFM Directive") published on July 13 (ESMA/2011/209, the

“July Draft Advice”) and August 23, 2011 (ESMA/2011/270, the “August Draft Advice” and together the “Draft Advice”).¹

2. The future impact of the AIFM Directive will be vast, not only for fund managers but also for all professional investors in Europe. The Directive will have a big impact on the relationships of the investors with EU and non-EU fund managers – to the extent that the latter market Alternative Investment Funds (AIFs) in the EU – across a very broad range of managers and funds. This ranges from those managing funds that trade in large numbers of liquid financial instruments and market to a diversified investor base, to those with a very limited numbers of professional investors for a limited number of investments into illiquid assets such as unlisted companies, land or real estate.
3. The AIFM Directive is a highly complex piece of legislation resulting from long and detailed negotiations and delegates authority to the European Commission to adopt implementing measures on a large number of issues that are specifically identified in the Level 1 text. It is important that ESMA’s final AIFMD advice (the “Final Advice”), and the Commission’s implementing rules as ultimately adopted, provide a balance between serving as a guidance to industry participants and competent authorities that is as concrete and practical as possible, while staying within the perimeters of the Level 1 text.

Perspective taken by the Stakeholders Group

4. In its analysis of the ESMA draft technical advice, the Stakeholder Group has taken the perspective that its advice to ESMA should focus on getting the balance described under paragraph 3 right, instead of possibly replicating some of the efforts already undertaken by other stakeholders in their more technical responses to the Draft Advice. Two key questions have been identified that could potentially impact the balance:

A. Does the Draft Advice strike the right balance in providing concrete guidance to industry participants and regulators whilst staying in line with the Level 1 text?

The aim should be to have a Final Advice in line with the stated purposes of the AIFM Directive, whilst also considering whether these objectives are achieved to the largest extent possible in a manner which impacts, as little as possible on the diversity and return of the investment opportunities offered to professional European investors. In a number of respects the delicate compromise of the AIFM Directive could be impacted by the Draft Advice which appears in several occasions to go further than what the Level 1 text intended. This could be an inevitable consequence of the high level character of Level 1, but could also lead to unintended consequences.

B. Does the Draft Advice implement the principle of proportionality?

The Stakeholder group has also taken the perspective that the Level 2 text must achieve the high level of protection for European investors – as required by Level 1 - whatever the product in which they invest or the manager with whom they engage, whilst also considering whether the right level of tailoring and proportionality in the rule setting is provided given the fundamental diversity and divergence in nature, scale and complexity of the different alternative investment fund (“AIF”) business models offered to professional investors in Europe. It could be that the Final Advice will benefit from a further consideration of this large divergence of investment fund propositions.

¹ References in this note to boxes and questions are to the July Draft Advice unless otherwise specified.

III. EXAMPLES

5. We have included a selection of concrete examples in respect of the Draft Advice for which we believe that answer to question A and/or B above may require reconsideration by ESMA:

Example 1: equivalence

6. Under the requirements for delegation ESMA introduces in Box 1 (*In the event of a delegation of portfolio or risk management to an undertaking in a third country, how co-operation between the home Member State of the AIFM and the supervisory authority of the undertaking should be ensured*) of the August Draft Advice the use of equivalence. This concept is used for determining if the undertaking to which the AIFM is going to delegate is subject to a regime of regulation at least 'equivalent' to that of the AIFMD. Without an equivalent regime, delegation will be difficult. The same applies to the August Draft Advice, which suggests that the regulatory regime of the non-EU depositary must include a liability regime equivalent to that of the AIFM Directive instead of regimes of the 'same effect' as set out in Level 1. The way in which equivalence is dealt with in the Final Advice is also important because this could also have an impact on the way similar concepts in other future European directives or regulations will be interpreted.
7. These equivalence suggestions seem to deviate from the requirements and intentions of Level 1 and could potentially impact the balance referred to in A and B above. In light of the unique nature of the AIFMD regime even undertakings or depositaries in other, well respected, countries with a high level of regulation might not even meet these equivalence tests (e.g. the US). This could potentially make delegation of portfolio or risk management functions to undertakings in third countries difficult.
8. In light of the aim of the AIFM Directive and the balance of the Level 1 text, having equivalence tests introduced at Level 2 could potentially lead to the investors the AIFMD aims to protect not being able to access valuable investments services offered outside of the EU. We hope that ESMA will be able to find a solution that meets both the aims of the AIFM Directive, while not leading to these potential consequences as this would bring no benefit to investors and managers alike. A possible solution could be simply sticking to the current Level 1 text, which could then lead to an effective delegation regime to undertakings in third countries without impeding on the objectives of the AIFMD. Alternatively, the existing UCITS and/or MiFID rules for delegation could perhaps serve as inspiration.

Example 2: preferential treatment

9. The Draft Advice makes suggestions around the types of preferential treatment that could have an overall material disadvantage to other investors and would be qualified as "unfair". However, Level 1 does permit preferential treatment as long as it is disclosed to investors and thereby – so we assume, as derived from the aim of the AIFM Directive – adequately protected. Therefore a suggestion by ESMA needs to be balanced against the comfort that investors draw - as a measure of investor protection- from full disclosure further to Level 1. In terms of the Final Advice we could see an option working whereby ESMA would leave this matter to the Level 1 text only and allow local market practices to take its course based on the high level principle contained in the AIFM Directive.

Example 3: depositary obligations

10. For the depositary to adequately perform its tasks - especially the obligation on the depositary to monitor the subscription and redemption process, it is critical for the depositor to be properly in-

formed, with entails certain information or approval rights. It is to be assessed whether the requirement on depositaries to carry out *ex ante* verifications of certain transactions – including the obligation to check the underlying legal structures of AIFs' investments and not only the ownership of AIFs' assets other than financial instruments – is in all instances required from an investor protection point of view. This does not become clear from the explanatory text to the Draft Advice.

Example 4: leverage

11. As the leverage definition in the AIFM Directive is based upon an in-depth analysis of the leverage mechanisms that have the potential or not to create systemic risk, it is critical to ensure at Level 2 that any indebtedness at the level of entities in which an AIF invests, is indeed fully isolated from the AIF and does not increase the exposure at the level of the AIF itself, including the absence of any guarantees given by such AIF for any borrowing at the entity level

Example 5: cooperation arrangements with third-country authorities.

12. The AIFM Directive provides that before delegation or marketing is allowed, certain cooperation arrangements with third-country authorities are required. These arrangements must provide for an exchange of information for the purpose of systemic risk oversight. The requirement that this exchange of information should be aimed at the performance of all duties under the AIFM Directive for an EU AIFM manager with a passport, could be reconsidered against the need of such information for systemic risk purposes and the risk of discontinued availability of a wide range of investment choices to EU investors, as such cooperation arrangements must be in effect by mid July 2013.
13. On the other hand, ESMA could provide stronger guidance which will be necessary for the complex system of cooperation arrangements envisaged by the AIFM Directive to operate effectively. The August Draft Advice helpfully suggests that ESMA should negotiate a single agreement with each relevant non-EU jurisdiction for purposes of permitting delegation of portfolio and risk management. However that advice suggests only, as regards the cooperation arrangements required for access to national private placement regimes, that ESMA would prepare a "template" for agreements that would then be negotiated on a bilateral basis which may not be satisfactory in view of the time pressure for such agreements on delegation being place to ensure continued access of European investors to non EU managers.
14. Equally, to ensure a smooth implementation of the third-country aspects of the AIFM Directive, which is critical for European investors, ESMA should assess whether the cooperation agreements contemplated by Article 21(1)(d) and those contemplated by Articles 34(1)(c), 36(1), and 42(1) can be negotiated centrally by ESMA.

Example 6: member state of reference

15. The Level 1 text calls for implementing measures on the procedures to be followed by Member State authorities when determining the Member State of reference where several are possible. The Level 1 text contains no relevant criteria for the most likely case, i.e. where a non-EU AIFM intends to market one or more non-EU AIFs in several or even all Member States.
16. The statement by the Draft Advice that ESMA was unable to identify any criteria to assist in determining the Member State of reference, could be reconsidered against the relevance of criteria such as the selection of a Member State of reference for another AIFM within the same group, the supervision of members of the AIFM's group by the authorities of a potential Member State of reference, the presence of entities within the AIFM's group in a potential Member State of reference with the capacity to act as legal representative, and the language of the potential Member State of reference versus the operating language of the AIFM.

Example 7: operating conditions: internal structures

17. The detailed requirements to maintain separate compliance and risk management structures and procedures overseen by individuals not compensated based on AIFs' performance, as proposed by the Draft Advice, could be reconsidered against the fact that many AIFMs in accordance with their business models have lean staffs, whereby the ultimate supervisory roles are often occupied by a few very senior individuals who typically co-invest in the AIFs managed by those AIFMs and whose interests ought to be aligned with those of investors. Part of the reconsideration process could be providing guidance how these types of institutions should comply with these requirements in light of the above.

Example 8: operating conditions: risk management

18. While the Draft Advice recognizes the need to tailor risk-management requirements for different business models, the Advice should assess the need to recognize that not all AIFs will be subject to the types of risk as identified in Box 20 (*Types of conflicts of interest between the various actors as referred to in Article 14(1)*), that not all of the arrangements, processes and techniques mentioned in Box 28 (*Measurement and Management of Risk*) will be appropriate for all AIFs and, in the case of AIFs making long-term investments in less liquid assets, quantitative risk measures may not be appropriate.

Example 9: MiFID & UCITS

19. The Draft Advice rightly uses some of the existing concepts under MiFID and UCITS as an inspiration and reference on how to interpret certain AIFM concepts at Level 2. However, given the very broad scope of the AIFMD, these existing UCITS or MiFID rules cannot provide appropriate guidance on all issues covered in the mandates by the Commission. The UCITS and MiFID rules should therefore serve as basis for ESMA's drafting, but the Level 2 rules should at the same time also be prepared in a proportionate and differentiated way in order to take into account the wide variety of structures under the scope of the AIFMD. It is especially important for ESMA to get this right because many concepts used in the AIFM will in their turn have a 'knock-on effect' on other future European directives, such as UCITS V, MiFID II and EMIR.

IV. CONCLUSION

20. In its analysis of the Draft Advice, the Stakeholders Group has focused on how the advice contributes to achieving the purposes of the AIFM directive: anticipate systemic risk and provide the appropriate level of investor protection. In the design of any new regulatory regime there is a risk of unintended consequences, especially where new rules are applied to a diverse industry. Although we feel that much has been accomplished in this respect by ESMA in the Draft Advice, potentially even more could be achieved by keeping a close eye on the fine balance between market stability and investor protection on the one hand and proportionality and diversity of investment opportunities offered to European investors at acceptable costs levels on the other hand. Our conclusion is that currently there are elements in the Draft Advice that could potentially impact this balance and may require reconsideration.

We would welcome the opportunity to discuss our views at your convenience and hope that these views will help ESMA in balancing its Final Advice.

This advice will be published on ESMA's website.



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Guillaume Prache
Chair
Securities and Markets Stakeholder Group