

November 2011


ESMA technical advice on AIFM implementing measures – a step forward but still some way to go

ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive was issued on 16 November 2011.

1. What does the advice cover?

The European Securities and Markets Authority's (ESMA's) advice covers requirements on *inter alia*:

- ▶ Alternative Investment Fund Managers (AIFM) which fall below the threshold, and which may therefore benefit from exemptions from the provisions of the Directive: calculation and monitoring of total assets of portfolios of alternative investment funds (AIFs) under management (AuM), the influence of leverage on AuM, information which such AIFMs are required to provide to their national competent authorities, opt-in procedure, etc.
- ▶ Types of potential risk arising from professional negligence, how these should be covered by additional own funds and professional indemnity insurance, and the management of operational risk
- ▶ Duty to act in the best interests of the AIF or the investors and the integrity of the market, due diligence, reporting of subscription and redemption orders, selection and appointment of counterparties and prime brokers, execution of dealing decisions, placing and handling of orders, inducements and fair treatment
- ▶ Conflicts of interest: types of conflicts of interest between actors, conflicts of interest policy, independence in conflicts management, recordkeeping, exercise of voting rights
- ▶ Risk management: permanent risk management function, functional and hierarchical separation, risk management policy, risk measurement and management, risk limits
- ▶ Liquidity management policies and procedures, limits and stress tests
- ▶ Investment in securitization positions
- ▶ Organizational requirements: procedures and organization, resources, electronic data processing, accounting procedures, senior management and supervisory function, permanent compliance and internal audit functions, personal transactions, recording of portfolio transactions, recording of subscription and redemption orders and recordkeeping
- ▶ Valuation: policies and procedures, models, frequency, reviews and net asset value (NAV) calculation

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- ▶ Delegation:
 - ▶ General principles, objective reasons, sufficient resources, experience and repute, conflicts of interest and prevention of effective supervision of the AIFM
 - ▶ In the case of delegation of portfolio management or risk management: types of institution authorized and registered for asset management and subject to supervision
 - ▶ In the case of delegation of portfolio management or risk management to entities established in third countries: appropriate cooperation agreements with third country supervisory authorities
 - ▶ Depositaries:
 - ▶ Appointment of a depositary: the contract evidencing the appointment and its content
 - ▶ Duties of the depositary:
 - ▶ Cash monitoring
 - ▶ Safe-keeping, including a definition of the financial instruments to be held in custody
 - ▶ Oversight
 - ▶ Delegation of part or all of safekeeping functions to a third party:
 - ▶ Due diligence duties
 - ▶ Segregation obligation for third parties
 - ▶ Depositary liability regime
 - ▶ Criteria for assessing whether the prudential regulation and supervision applicable to a depositary established in a third country with respect to its duties are to the same effect as the provisions laid down in EU law
 - ▶ Method for calculating the leverage and the exposure of an AIF
 - ▶ Limits to leverage or other restrictions on the management of AIF
 - ▶ Transparency requirements: annual reporting, including remuneration, disclosure to investors and reporting to competent authorities
 - ▶ Supervision

In the light of ESMA's advice, the European Commission is expected to release the final AIFM Directive implementing measures (also known as Level 2 measures) by July 2012, one year before the AIFM Directive transposition and compliance deadline.

We expect the European Commission's final implementing measures will closely follow ESMA's advice. However, the Commission has indicated its readiness to further consult with industry representatives and stakeholders on some issues before finalizing the implementing measures, in particular to ensure that they are aligned with the spirit of the Level 1 AIFM Directive. Such issues may include the definition of "external event" in the context of the depositary liability regime, and the template for reporting by AIFM to competent authorities.



2. What is the impact?

We now have both the AIFM Directive and the almost complete implementing measures, which, going forward, we recommend be considered as a single package. The AIFM Directive and its implementing measures will substantially impact AIFM and their AIF, service providers and investors. The alternatives industry being very varied, the extent of the impact will depend heavily on the asset classes as well as the nature, scale and complexity of the group, the AIFM and AIF.

In our view, AIFM should align their product range with the post-AIFM needs of investors, and organizational model with the new opportunities and obligations before tackling the specific AIFM compliance challenges.

For many, meeting the organizational requirements outlined in the implementing measures will be particularly challenging from a compliance perspective; the extent of the changes to be implemented should not be underestimated. For example, the implementing measures:

- ▶ Require AIFM to establish, implement and maintain decision-making procedures and a documented organizational structure defining reporting lines and allocating functions and responsibilities
- ▶ Lay down the control responsibilities of the senior management and, where appropriate, supervisory function, which are primarily ensuring compliance with the AIFM's obligations under the Directive
- ▶ Require AIFM to establish, implement and maintain adequate internal control mechanisms, with permanent compliance, internal audit and risk management functions, in some cases taking account of the nature, scale and complexity of the business

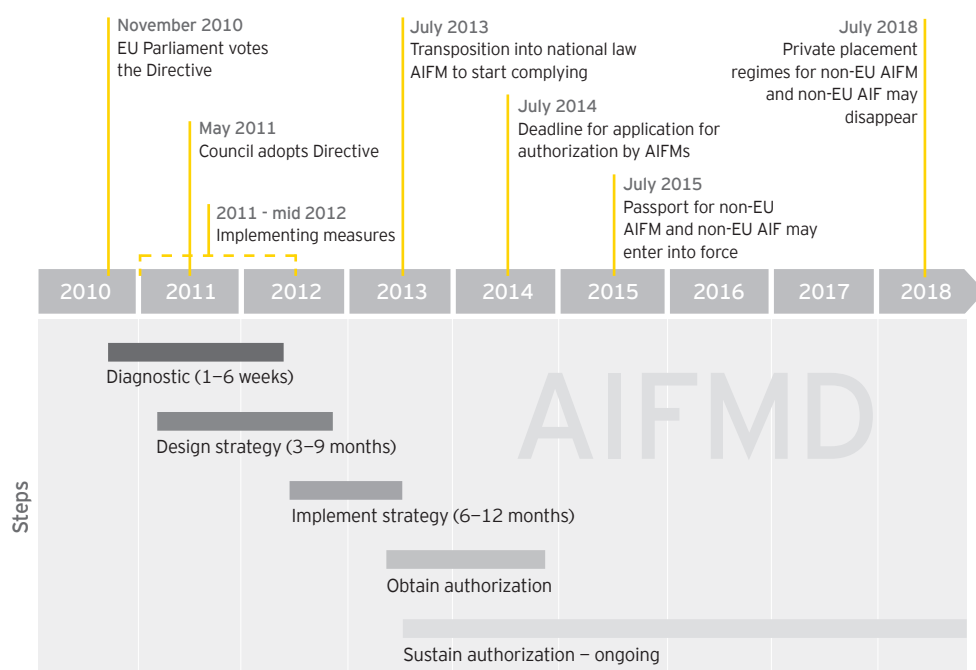
From a service provider perspective, the implementing measures on the depositary are particularly significant; they clarify the depositary's duties, delegation of duties, and liability. A particularly important issue relates to the depositary's cash flow monitoring duties; we welcome ESMA's opting for what we see as the more workable, less onerous, option. Looking forward towards implementation, the requirement to appoint a depositary will be a new obligation for some AIFM, particularly in Private Equity. AIFM will need to come to terms with the role of the depositary under the new regime, and get used to working together with the depositaries of their AIF. For example, some may initially find some depositary oversight "intrusive". Meeting the depositary requirements will mean additional cost, most of which is likely to be borne by the AIF investors.

Looking forward, investors need to define their approach to AIFM Directive compliant versus non-compliant products. The AIFM Directive and its implementing measures is likely to mean more coherent, and in some cases more complete, disclosure (for example, on risk management). AIFM Directive compliance will provide comfort to many investors; they may refocus their due diligence procedures. However, AIFM will also mean additional fees to cover compliance with the Directive, both at manager and service provider levels.

3. Implementation timeline

Considering the potential substantial impact of AIFM and the implementation deadlines, we believe that AIFM and their service providers should first perform a diagnostic to contextualize the AIFM Directive, get an initial picture of their readiness and assess the amount of work that may be required from strategic and compliance perspectives.

AIFM Directive implementation timeline



Conclusion: how Ernst & Young can help?

Ernst & Young is ready to support AIFM and service providers during the entire implementation process.

As a first step, our Quickscan tool supports AIFM and their service providers in their initial diagnostic assessment of the operational impacts of the Directive.

Ernst & Young then supports AIFM in defining their post-AIFM product ranges and organizational models, and guiding them through the implementation phase. We are helping service providers, such as depositaries, to implement an operational framework which meets the requirements of the Directive.

Ernst & Young is also helping several industry bodies to develop common models for their members as they face the challenge of implementing the Directive.

In Luxembourg, Ernst & Young's Alternative Investment Fund Club provides alternative industry practitioners with a platform to meet, exchange views and network, benefiting from Ernst & Young's insight into the alternative sectors and the specific challenges they face. At the Club's event for AIF depositaries in early November 2011, Ernst & Young presented an overview of its operational framework for depositaries in the light of the AIFM Directive. In late November, the Club is organizing *The AIFMD Challenge: Crossing the line*, an event illustrating how to apply the detailed implementing measures in critical areas; in December 2011, the Club will focus on *Risk and liquidity management in real estate funds* and present a *Survey on the effects of the AIFMD on private equity 2011*. Further information is available on our website: www.ey.com/lu/aif-club

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