SHEARMAN & STERLING LLP

CLIENT PUBLICATION

INVESTMENT FUNDS

12 December 2011

European Regulation of Fund Managers: ESMA's Final "Level 2" Advice Published

The EU Alternative Investment Fund Managers Directive[1] (the "Directive") came into force on 21 July 2011. The Directive promises to reshape the regulation of managers of alternative investment funds in the EU and beyond, and is required to be implemented across the EU by 22 July 2013. Yet the Directive requires significant rulemaking in the form of so-called Level 2 implementing measures in order to put flesh on its bones. The body tasked with bringing forth those implementing measures, the European Commission (the "Commission"), has now received final advice from the European Securities and Markets Authority ("ESMA"). That advice, upon which the Commission is expected to rely heavily in its own rulemaking, has been the subject of fierce debate during consultation. This note analyses ESMA's Final Advice and the possible consequences for the fund management industry going forward.

Introduction

After two years of development, argument and fine-tuning, the Directive was finally published in the Official Journal of the European Union on 1 July 2011 and entered into force for European law purposes on 21 July 2011. EU Member States are required to implement the Directive by 22 July 2013.

Although the Directive is principally concerned with the regulation of EU fund managers, its scope means that the Directive also has significant implications for non-EU managers. The Directive subjects EU alternative fund managers to pan-European regulation and represents a watershed moment for the European alternative funds industry and the EU's willingness to extend its regulatory purview over non-EU managers.

[1] Directive 2011/61/EU.

The provisions of the Directive were analysed by us in a previous client publication[2]. But the content of the Directive itself represents only part of the equation: implementing measures promulgated by the Commission will contain crucial details that will determine how the Directive will operate in practice. The Commission will rely heavily on the advice of ESMA when formulating its Level 2 measures, which are expected to be adopted in July 2012.

In July 2011, ESMA published a Consultation Paper containing its draft advice and invited comment on a number of options that ESMA indicated it was considering adopting in its Final Advice. Many respondents to the Consultation Paper sought more clarity from ESMA in its Final Advice and baulked at some of the more unworkable options. ESMA aimed to address these issues in its Final Advice published on 16 November 2011.

ESMA's proposals are intended to provide detail and clarification on a broad swathe of the Directive's provisions relating to issues such as depositary liability, transparency, leverage and supervision.

Publication of the Final Advice signifies an important landmark in the Directive's legislative process. The near conclusion of the second stage of implementation brings the Directive's regulatory regime within touching distance and allows AIFMs, their advisers and the alternative funds community at large to more fully analyse the Directive's true impact.

[2] Available at http://www.shearman.com/european-regulation-of-fund-managers-aifm-directive-agreed-and-adopted-11-12-2010.

Table of Contents

Lighter Regime for Smaller Fund Managers

The Directive provides exemptions from certain aspects of the regulatory regime for an Alternative Investment Fund Manager ("**AIFM**") that has:

- Assets under Management ("**AUM**") of less than €100 million; or
- AUM of less than €500 million, but only if its funds are unleveraged and investors are not permitted to redeem their investments for five years.[3]

An AIFM falling within either of these categories is only required to register with regulators rather than become authorised (although such an AIFM can 'opt in' to the Directive and become authorised if it so wishes).[4] While registration avoids the vast majority of requirements imposed by the Directive, a registered AIFM will not enjoy the principal benefit of the Directive: the ability to easily market funds across Europe on a passported basis.[5]

ESMA's Final Advice focuses on how AUM is calculated for the purposes of the two categories described above. That calculation must include assets acquired through leverage and the value of any derivative positions held[6], but should exclude any assets of a UCITS[7] fund managed by the AIFM. Sense prevailing, no 'double counting' would be required where one fund managed by an AIFM invests in another fund managed by the same AIFM.

A registered AIFM should calculate AUM at least annually in order to determine its continued eligibility for registered status.

Temporary increases in AUM over the relevant threshold will not trigger authorisation, unless it is expected that the "temporary" increase will last for more than three months.[8]

Capital Requirements, Own Funds and Professional Indemnity Insurance

The Directive subjects AIFMs to minimum capital requirements.[9] AIFMs must generally have initial capital of at least €125,000 plus 0.02% of the amount by which the AIFM's AUM exceed €250 million.[10]

Own Funds

In addition to capital requirements, the Directive requires that all AIFMs have adequate funds to cover professional liability risks (or hold adequate insurance for such risks).[11]

[3] Directive, Article 3(2).

[4] Directive, Article 3(4).

[5] Directive, Article 3(4).

[6] Final Advice, Box 1, Paragraphs 2 and 3.

[7] Directive 2009/65/EC.

[8] Final Advice, Box 1, Paragraph 6.

[9] Directive, Article 9.

[10] Directive, Article 9(2). Self-managed funds are subject to a flat initial capital requirement of €300,000.

ESMA believes the risks requiring coverage include:[12]

- losses due to dishonest, fraudulent or malicious acts;
- losses arising from a negligent failure to meet a professional obligation to investors and clients; and
- losses arising from a negligent failure that results in a business disruption or a system failure.

As a minimum, an AIFM's own funds requirement will be equal to 0.01% of AUM[13]. Although apparently a 'blunt tool', basing the minimum 'own funds' requirement on AUM is preferable to an alternative that was mooted in the Consultation Paper. That would have required an 'own funds' requirement to be based not only on AUM, but also on the fees and commissions received by the AIFM during the preceding three years. It is difficult to see how fee income could be a useful barometer of the risk of professional negligence.

Fiduciary Duties

The Directive contains a number of high level principles with which an AIFM is expected to comply at all times. Among other things, an AIFM must act honestly and with due skill, care and diligence in conducting its business.[14] These are standards traditionally applied to a fiduciary.

In addition, the Directive requires that an AIFM:

- act in the best interests of the fund (or its investors) *and* the integrity of the market; and
- treat all investors in its funds fairly.

These duties have caused particular consternation among commentators. While the interests of the fund (and/or its investors) and those of the market may frequently be aligned, this may arguably not always be the case (e.g., in the case of aggressive short selling). The result of this is that it may at times be impossible for an AIFM to act both in the interests of the fund and its investors, and in the interests of the "integrity of the market" at the same time.

Similarly, it is possible to envisage situations where the interests of different investors may conflict—such as in the case of gating—making it difficult for an AIFM to treat all investors 'fairly' within the meaning of the Directive.

ESMA's Final Advice offers some clarity on these points. First, ESMA suggests that AIFMs should implement and apply appropriate policies and procedures for preventing malpractices that might reasonably be expected to affect the stability and integrity of the market.[15] Second, ESMA suggests that AIFMs should act in such a way as to prevent undue costs being

[11] Directive, Article 9(7).

[12] Final Advice, Box 5.

[13] Final Advice, Box 7, Paragraph 1.

[14] Directive, Article 12(1)(a).

[15] Final Advice, Box 10, Paragraph 1.

charged to the fund and its investors.[16] Third, ESMA suggests that treating investors "fairly" includes that no investor may obtain preferential treatment that has an overall material disadvantage to other investors.[17]

ESMA was deliberate in not providing an 'all-encompassing' definition of fair treatment. ESMA believes that an overly rigid definition may weaken investor protection by preventing competent authorities from taking action against unfair treatment that does not fall strictly within the definition.[18] While an understandable sentiment, it results in AIFMs having to determine, with their advisers, what unspecified 'unfairness' may be targeted by regulators in the future.

Inducement Payments

ESMA's Final Advice suggests that an AIFM will breach its fiduciary duty if the AIFM pays or receives fees or commissions, or provides or is provided with a non-monetary benefit, other than in certain circumstances[19]. Those circumstances include:

- a payment or benefit to or from the fund (e.g. a management fee);
- a payment or benefit to or from a third party which is both disclosed to the fund (and its investors) and "enhances the quality" of the AIFM's service; or
- a payment of a fee which is necessary for the provision of the AIFM's service (such as settlement or exchange fees).

Payments to third party distributors will therefore need to be disclosed. In addition, though, any such payments must be designed to "enhance the quality" of the AIFM's service. It appears from the Final Advice that ESMA acknowledges that third party marketing can indeed "enhance the quality" of the AIFM's services.

Conflicts of Interest

The Directive[20] requires an AIFM to take all reasonable steps to identify conflicts of interest that arise between:

- the AIFM and a fund it manages;
- two funds managed by the AIFM;
- a fund and another client of the AIFM;
- two of the AIFM's clients; and
- an alternative investment fund and a UCITS managed by the AIFM.

An AIFM must have arrangements in place and take all reasonable steps to identify, prevent, manage and monitor conflicts of interest so as to prevent the possibility of those conflicts adversely affecting the interests of a fund and its investors.

[16] Final Advice, Box 10, Paragraph 2.

[17] Final Advice, Box 19.

[18] Final Advice, Page 51, Paragraph 38.

[19] Final Advice, Box 18.

[20] Directive, Article 14.

ESMA was asked by the Commission to identify, in its advice, the types of conflicts of interest that may arise for an AIFM. In its Final Advice, ESMA highlights some examples of where a conflict may arise (e.g. where the AIFM is likely to make a financial gain at the expense of a fund, where there is an incentive to favour one fund over another, or where there is an incentive to favour one investor over another).[21] In addition, an AIFM would be required to establish, implement and maintain an effective conflicts of interest policy, and keep records of activities that generate conflicts of interest. Each of these is in line with existing, equivalent requirements under the MiFID[22] and UCITS Directives.

Valuation of Assets

The Directive requires an AIFM to establish procedures that ensure a proper and independent valuation of fund assets at least once a year.[23] ESMA's Final Advice states that calculation of the net asset value per unit/share ("**NAV**") should take place upon every subscription or redemption of units or shares.[24] This is unlikely to prove controversial for managers of open-ended funds, who will likely be performing NAV calculations frequently in any event. However, for many closed-ended funds, though a calculation of NAV on any subscription will not be typical currently, it will often be difficult and may be of little benefit for investors.

The Final Advice also requires that an AIFM implement written policies and procedures in order to ensure that valuations are sound, transparent and appropriately documented.[25]

Delegation

The Directive's provisions on delegation[26] have caused significant concern for AIFMs. The Directive requires an AIFM to notify its regulator prior to any delegation[27] (but note ESMA's Final Advice limiting this, discussed below) and imposes pre-conditions for any such delegation. Those conditions include:[28]

- the AIFM must be able to objectively justify its entire delegation structure;
- the delegate must have sufficient resources to perform its delegated functions, and be sufficiently experienced and of good repute;
- where the delegation is of management functions, the delegate must be either (i) authorised or registered as an asset manager, and supervised as a result or (ii) approved in advance by the AIFM's regulator;
- non-EU delegates are only permitted if "cooperation" between the AIFM's regulator and the regulator of the non-EU entity is 'ensured';

[21] Final Advice, Box 20.

[22] Directive 2004/39/EC.

[23] Directive, Article 19.

[24] Final Advice, Box 60.

[25] Final Advice, Box 55.

[26] Directive, Article 20.

[27] Directive, Article 20(1).

[28] Directive, Article 20(1).

- the AIFM must be able to effectively monitor the delegation, give instructions to the delegate, and cancel the delegation with immediate effect if to do so would be in the interests of investors; and
- the delegation must neither prevent the AIFM acting in the best interests of investors, nor prevent the effective supervision of the AIFM by its regulators.

ESMA was asked to advise the Commission as to possible implementing rules surrounding these conditions.

Critical or Important Tasks

Very helpfully, ESMA suggests that an AIFM must comply with the Directive's provisions on delegation only where the delegation is of a function which is "critical or important".[29] A function will be "critical or important" if a defect or failure in its performance would materially impair either the AIFM's compliance with the Directive or other regulatory obligations, or the AIFM's financial performance, or the functions it performs.[30]

The Final Advice incorporates a non-exhaustive list of tasks that will not be considered "critical or important".[31] These include:

- the provision to the AIFM of advisory services that do not form part of the management function (e.g., legal or accounting advice);
- the purchase of standardised services;
- the provision of logistical support (e.g. cleaning, catering and secretarial services);
- participation in securities settlement systems and payment systems; and
- buying standard software 'off the shelf'.

ESMA's intention appears to be to restrict the scope of the Directive to delegated functions that are likely to have an impact on fund performance and/or the 'build up' of systemic risk. This is a proportionate and realistic outcome, given the Directive's stated aims.

Letter Box Entities

The Directive prevents an AIFM from delegating its functions to the extent that it becomes a "letter-box entity". It was left to ESMA to explain what a "letter-box" entity was. The Final Advice[32] provides that an AIFM will become a letter-box entity where:

[29] Final Advice, Box 63, Paragraph 1.

[30] Final Advice, Box 63, Paragraph 2.

[31] Final Advice, Page 123, Paragraphs 11.

[32] Final Advice, Box 74.

- the AIFM no longer retains the necessary expertise and resources to supervise and effectively manage the delegation; or
- the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions.

General Principles of Delegation

ESMA's Final Advice also contains general principles on delegation that should be observed by an AIFM at all times.[33] These include:

- the delegation should not absolve senior management within the AIFM of their responsibilities;
- the AIFM should monitor the delegate and ensure that all delegated tasks are carried out effectively; and
- the AIFM must ensure, as far as possible, that a delegate discloses to the AIFM any development that may have a material impact on its ability to carry out the delegated functions effectively.

In broad terms, these principles either echo the Directive itself or represent (with the possible exception of the third bullet point above) current market terms included in many delegation agreements.

Objective Justification for Delegation

The Directive requires that AIFMs objectively justify their entire delegation structure.[34] According to ESMA, this means that an AIFM must be able to show that any delegation is done for the purpose of a "more efficient conduct" of the AIFM's management of the fund. A non-exhaustive list of acceptable reasons is provided by ESMA and includes:[35]

- optimising business functions and processes;
- cost saving;
- expertise of the delegate; and
- access of the delegate to global trading capabilities.

The result of the Commission adopting ESMA's Final Advice on this point would be that an AIFM would generally enjoy broad powers of delegation, and be entitled to rely on what amounts to a list of "safe harbours" that will, in practice, capture most reasons for delegation.

[33] Final Advice, Box 64, Paragraph 1.

[34] Directive, Article 20(1)(a).

[35] Final Advice, Box 6.

Identity of the Delegate

The Directive requires that a delegate has sufficient resources to perform its delegated functions, as well as staff that have sufficient experience and are of good repute.[36]

The Final Advice places the emphasis on the AIFM to assess whether or not the above requirements have been met.[37] As part of that assessment, an AIFM should consider:

- whether the delegate employs sufficient personnel with the skill, knowledge and expertise necessary to discharge the tasks delegated to it;
- whether the delegate's employees have appropriate theoretical knowledge (education and formal training) and practical experience to perform their relevant functions; and
- whether the employees of the delegate have committed criminal offences or been the subject of relevant judicial proceedings or administrative sanctions.

A delegate established and regulated in the EU will generally be deemed to be of "good repute" unless there is evidence to the contrary.[38] There is no equivalent 'deeming' of delegates established and/or regulated elsewhere.

Delegation of Portfolio and/or Risk Management

Any delegation of management functions must, under the Directive, be to a delegate that is either (i) authorised or registered as an asset manager or (ii) approved in advance by the AIFM's regulator. Under ESMA's Final Advice, a firm will be "authorised or registered" for asset management if it is:[39]

- a UCITS Manager;
- an EU regulated investment manager (i.e., authorised under MiFID);
- a credit institution authorised to perform portfolio management under MiFID;
- another authorised AIFM (excluding a self-managed fund); or
- in certain circumstances, a non-EU fund manager (discussed below under "Third Country Provisions").

Depositaries

The provisions of the Directive relating to depositaries—and in particular the near-strict liability of a depositary—have been the subject of intense controversy. The idea that each fund should appoint a depositary to hold assets will be familiar to UCITS fund managers. Yet the Directive and ESMA's Final Advice take depositary liability, in particular, to a degree even

[36] Directive, Article 20(1)(b).

[37] Final Advice, Box 66.

[38] Final Advice, page 128, Paragraph 28.

[39] Final Advice, Box 67.

beyond that currently applicable to retail (i.e., UCITS) funds. As discussed below, the consequences of that for the European alternative funds industry could be significant.

Appointment of a Depositary

An AIFM must ensure that for each fund it manages,[40] a single depositary is appointed to hold that fund's assets.[41] That appointment must be by way of written contract.

In its Final Advice, ESMA declined to provide the Commission with a 'model contract' (recognising that a contract dealing with all types of funds would be near-impossible to generate). Instead, ESMA suggests that any contract of appointment would need to deal with matters such as[42]:

- a description of the services to be provided by the depositary;
- a description of the types of assets that will be entrusted to the depositary;
- a statement that the depositary's liability shall not be affected by any delegation of its custody functions (unless it has transferred liability to a delegate in accordance with the Directive);
- the means and procedures by which the depositary and the AIFM will transmit information to each other to enable duties to be properly performed; and
- details of any rights of re-use/rehypothecation given to the depositary or a sub-custodian.

Safe-Keeping of Assets

The depositary's primary role is to hold the fund's assets.[43] An obligation to hold assets in custody sounds straightforward enough. Yet, because the Directive applies to all forms of alternative funds (hedge, private equity, real estate etc.), many assets belonging to a fund either will not be capable of being held in custody, or will be posted as collateral with a prime broker, clearing house or other person. Part of ESMA's task in producing its advice to the Commission was to explain what assets a depositary would be capable of holding in custody. That explanation would be crucial, since a depositary's near-strict liability under the Directive is limited to assets held in its (or a sub-custodian's) custody.

ESMA proposes that financial instruments should be included in the scope of the depositary's custody function when[44]:

- they are (i) transferable securities, money market instruments or units of collective investment undertakings (i.e. funds); (ii) not provided as collateral (this is discussed in more detail below); and (iii) registered or held in an account directly or indirectly in the name of the depositary; or

[40] Excluding non-EU AIFs not marketed in the EU.

[41] Directive, Article 21(1).

[42] Final Advice, Box 75.

[43] Directive, Article 21(8).

[44] Final Advice, Box 79.

- they are capable of being physically delivered to the depositary.

When holding custody of financial instruments, the Final Advice states that the depositary must ensure that the instruments are properly registered in segregated accounts and exercise due care at all times.[45] In addition, the depositary must assess and monitor all relevant custody risks and inform the AIFM of any material risk identified. This obligation to monitor and assess custody risks continues even where the depositary has delegated to a sub-custodian.

When are Assets Provided as Collateral?

Financial instruments will not be "held in custody"[46] if, in broad terms, they are provided as collateral under either:

- a title transfer financial collateral arrangement (an EU-recognised concept) or equivalent in a non-EU jurisdiction. In this case, actual ownership of the instruments would technically transfer to the collateral taker; or
- a security financial collateral arrangement (also an EU-recognised concept), or equivalent in a non-EU jurisdiction, if as a result the control or possession of the instruments is transferred to a third party (i.e., not the depositary or the fund itself). In this case, the collateral is provided by way of security but the actual ownership of the instruments remains with the collateral provider.

In essence, these scenarios contemplate either that the fund no longer legally owns the asset, or that neither the fund nor the depositary has control over the instruments any longer. In either case, ESMA is effectively recommending to the Commission that the depositary should not be automatically liable for loss of these assets because the assets are no longer within its control. That is an understandable position. It is, however, somewhat at odds in principle with ESMA's views of a depositary's liability for the acts and omissions of third party sub-custodians (discussed below).

A depositary that has a right of re-use/rehypothecation over assets held by it will—even if that right of re-use/rehypothecation is exercised—be treated as holding the relevant financial instruments in custody (and consequently be held liable for losses of those instruments). This is hard to reconcile with ESMA's categorical statement in the Final Advice that any financial instruments provided under a financial collateral arrangement will not be "held in custody". It is possible that ESMA intends that the categorical statement should only apply to collateral providers other than the depositary. This is not, unfortunately, clarified in the Final Advice, despite the issue being raised with ESMA during consultation.

Depositary Liability

One of the most controversial aspects of the Final Advice is the approach taken by ESMA in relation to liability of the depositary. Under the Directive, a depositary will be held liable for the loss of assets unless it can prove that "the loss is due

[45] Final Advice, Box 80.

[46] Final Advice, Box 79.

to an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary".[47]

ESMA's view in consultation—and this view has not changed in the Final Advice despite overwhelming criticism—is that any act or omission of a sub-custodian will automatically be an "internal event" of the depositary, thus triggering near-strict liability. This is the case even where the sub-custodian is entirely unrelated to the depositary. That raises the prospect of a depositary being liable for the fraudulent acts of an unaffiliated sub-custodian – an event which many would see as being outside the control of the depositary and thus "external".

Transfer of Liability

In taking such a position, ESMA is presumably expecting depositaries to take advantage of the "transfer of liability" provisions in the Directive. These allow a depositary to avoid liability for a sub-custodian where the fund (or AIFM) has a direct contractual claim against the sub-custodian. But there are question marks over the usefulness of this 'get-out'. As a commercial matter, a sub-custodian will need to agree to a transfer of liability – which will not be guaranteed in all cases. Second, as a legal matter, there are only two ways of giving the fund/AIFM a direct right against a sub-custodian: either by the fund or the AIFM becoming party to a sub-custody agreement, or by virtue of third party rights arising under local law (such as under the UK's Contracts (Rights of Third Parties) Act 1999). The former could require swathes of contractual relationships with sub-custodians; the latter may not be available at all, depending on the law governing the sub-custody arrangements.

Consequences of ESMA's Approach on Liability

It seems likely that, if the Commission adopts ESMA's approach to depositary liability, fees charged by depositaries will increase, as depositaries price the new risks of near-strict liability. The extent of any increase will depend on factors such as (i) the extent to which potential liabilities of depositaries are insurable (responses to ESMA's Consultation Paper generally suggested not) and (ii) the ability of depositaries to transfer liability to sub-custodians. But one study commissioned as part of a response to ESMA's Consultation Paper suggested that fees charged by depositaries for their services could increase dramatically—possibly by up to four or five times current fee levels—with fund performance and investor returns suffering as a result.

Another consequence could be a less populated pool of depositaries willing to provide the service. Some smaller custodians could judge the potential risks as outweighing the benefits of acting as depositary, and simply not provide the service. Paradoxically, that would result in a concentration of service providers and potentially increase systemic risk (while a stated aim of the Directive was to reduce systemic risk). For those depositaries that are willing to provide services under the Directive, the prospect of liability for the fraud of some sub-custodians, in some markets, may be too much risk to bear. An AIFM may thus find itself limited in the markets that it is able to access. None of these are desirable outcomes. If ESMA's

[47] Directive, Article 21(12).

approach to depositary liability is taken forward by the Commission, it will be essential that the 'transfer of liability' provisions are utilised efficiently in any AIFM's custody network.

Cash Flow Monitoring

In addition to its custodial role, the Directive has assigned depositaries the task of ensuring that a fund's cash flows are properly monitored.[48] The Final Advice requires that depositaries ensure that there are proper procedures to reconcile all cash flow movements and verify that they are performed at appropriate intervals.[49] The depositary must also ensure that appropriate procedures are implemented to identify "significant" cash flows. That includes, in particular, any cash flows which could be inconsistent with the fund's operations.[50] A depositary must review its procedures at least annually. Additionally, the depositary must monitor the outcomes and actions taken as a result of complying with its procedures and alert the AIFM if an anomaly has not been rectified without undue delay.

It is of some relief that the Final Advice does not require that a depositary act as a 'central hub' for all the fund's cash movements (which had been suggested in ESMA's original Consultation Paper). Requiring the depositary to act as a central hub would likely have been disproportionately costly and administratively difficult to effect.

Transparency Requirements

The Directive imposes wide-reaching disclosure and reporting obligations on AIFMs, including a requirement that regulators (and investors on request) be provided with an annual report for each fund managed. In its Final Advice, ESMA provides much of the detail surrounding these obligations.

Annual Report: Remuneration Disclosure

The Directive requires[51] that an AIFM detail, in its annual report, information relating to the remuneration of its employees. The total amount of remuneration paid by the AIFM to its staff must be disclosed, split into fixed (salary) and variable (bonus) remuneration.[52] Separately, the remuneration of senior management and members of staff of the AIFM whose actions have a "material impact on the risk profile" of the fund must be disclosed.[53]

The Final Advice provides that a disclosure should state to whom the disclosed remuneration relates (i.e., the entire staff of the AIFM, or members of staff allocated to a particular fund) and the number of people to whom the remuneration relates.[54] The unfortunate consequence may be that, for smaller AIFMs, the information disclosed is such that it becomes possible for

[48] Directive, Article 21(7).

[49] Final Advice, Box 78, Paragraph 2.

[50] Final Advice, Box 78, Paragraph 3.

[51] Directive, Article 22(2).

[52] Directive, Article 22(2)(e).

[53] Directive, Article 22(2)(f).

[54] Final Advice, Box 107, Paragraph 2.

investors and others to deduce how much particular individuals have been paid, as well as the structure of that remuneration.

Disclosures to Investors: Liquidity and Risk

The Directive requires information on the liquidity of fund assets, a fund's risk profile and a fund's risk management system to be disclosed "periodically" to investors.[55] ESMA's view is that "periodically" means: (i) in relation to liquidity arrangements, whenever material changes are made to the liquidity management policies and procedures of the Fund; (ii) in relation to a fund's risk profile, at least annually (more frequently if required by the fund's rules); and (iii) in relation to risk management, whenever there are material changes to the risk management systems of the AIFM.

Disclosures to Regulators

The Directive requires that an AIFM provide regulators with information on the principal markets and instruments in which the AIFM trades, and information regarding the principal exposures and concentrations of each fund that it manages.[56] ESMA's Final Advice sets out the required frequency of reporting that information.

ESMA distinguishes between:

- small AIFMs (AUM of less than €100 million or €500 million (if unleveraged)) - reporting required annually;
- medium sized AIFMs (AUM of more than €100 million or €500 million (if unleveraged), but less than €1.5 billion of AUM) - reporting required semi-annually; and
- larger AIFMs (AUM of more than €1.5 billion) - reporting required quarterly[57].

Bizarrely, and clearly in error, the Final Advice does not deal with AIFMs that have AUM of exactly €100 million, €500 million (if unleveraged) or €1.5 billion.[58]

The staggered frequency adopted by the Final Advice represents a shift from ESMA's original thinking. In its Consultation Paper, ESMA had proposed that all AIFMs, regardless of size, report to regulators on a quarterly basis. Many saw this approach as excessive and disproportionate, weighing heavily on regulators who would be expected to gather, analyse and disseminate the disclosed information.

The Final Advice appears to have taken these concerns on board, which should help to streamline the administrative burden on EU regulators as they get to grips with the new regulatory regime.

[55] Directive, Article 23(4).

[56] Directive, Article 24(1).

[57] Final Advice, Box 110, Paragraph 4.

[58] Final Advice, Box 110, Paragraph 4.

Disclosures Relating to Leverage

The Directive requires that details of leverage actually used by a fund be disclosed to investors on a "regular basis".[59] ESMA's Final Advice proposes that this disclosure obligation be triggered every time there is a material change to the maximum leverage level of a fund.

Additionally, under the Directive, any AIFM that employs leverage on a "substantial basis" must provide regulators with detailed information, including the total amount of leverage employed by each fund managed by the AIFM; details of any rehypothecation/re-use of the fund's assets; the identity of the five largest sources of borrowed cash/securities; and the actual amounts borrowed.[60]

ESMA's view is that it is for the AIFM itself to decide whether or not it employs leverage on a substantial basis.[61] In its assessment, though, ESMA advises that an AIFM should consider:

- the type of funds under management, including their nature, scale and complexity;
- the investment strategies of the AIFM;
- the market conditions in which the funds and the AIFM operate;
- whether the exposures of a fund arising through the use of leverage could constitute an important source of market risk, liquidity risk or counterparty risk to a credit institution or other systemically relevant institution;
- whether the techniques employed by the AIFM through use of leverage could contribute to the aggravation or downward spiral in the prices of financial instruments or other assets in a threatening manner; and
- whether the degree of leverage employed by a fund could contribute to the build up of systemic risk in the financial system or the risk of disorderly markets.

Limits on the Use of Leverage

The Directive does not impose any flat limits on leverage. Instead, an AIFM is required to set reasonable leverage limits for each fund that it manages and must be able to demonstrate compliance with those limits.[62] In addition, the Directive gives EU Member States powers to impose limits on the amount of leverage that an AIFM can employ, but only where such a measure is necessary to "ensure the stability and integrity of the financial system".[63]

ESMA interprets the Directive as meaning that an EU regulator may impose limits on an AIFM's use of leverage (and other restrictions on the management of the fund) if such use of leverage could increase systemic risk in the financial system or

[59] Directive, Article 23(5).

[60] Directive, Article 24(4).

[61] Final Advice, Box 111.

[62] Directive, Article 25(3).

[63] Directive, Article 25(7).

create disorderly markets.[64] In ESMA's view, that will include a situation where leverage contributes towards a "downward spiral" in the prices of financial instruments.

It is arguable that ESMA's advice in this area goes beyond the powers granted to it in the Directive. The Directive provides for competent authorities to consider limiting leverage only in exceptional circumstances.

Third Country Provisions

The Directive's treatment of third country (non-EU) funds and AIFMs has been particularly controversial. The final third country provisions in the Directive are extremely detailed and complex. ESMA was asked to give advice to the Commission on delegation to non-EU entities, the use of non-EU depositaries, and supervision (relationships between EU and non-EU regulators).

Delegation

The Directive provides that where there is a delegation of portfolio or risk management to a non-EU undertaking, there must be 'cooperation' between the competent authority (regulator) of the AIFM's home Member State and the regulator of the non-EU delegate.[65]

According to ESMA's Final Advice,[66] a written arrangement between the two regulatory authorities will be sufficient to satisfy this "cooperation" requirement. ESMA provides a fairly comprehensive list of required contents of such a written arrangement. In particular, it should allow the EU regulator to:[67]

- obtain, on request, access to the information and documents necessary for the carrying out of its supervisory tasks;
- carry out on-site inspections of the non-EU delegate (the cooperation arrangement should also outline the practical procedures for such inspections);
- promptly receive relevant information from the non-EU regulator in the event of a breach (by the non-EU delegate) of the Directive; and
- ensure that "sufficiently dissuasive" enforcement actions can be implemented in the event of a breach of the Directive by the non-EU delegate.

These cooperation requirements are in addition to the basic requirement—applicable to all delegates of management functions—that the delegate be authorised or registered as an asset manager. It will be sufficient, for this purpose, if the non-EU delegate is authorised or registered for asset management according to 'local criteria' and is supervised by an independent competent authority.[68]

[64] Final Advice, Box 101, Paragraphs 1-3.

[65] Directive, Article 21(1)(d).

[66] Final Advice, Box 68, Paragraph 1.

[67] Final Advice, Box 68, Paragraph 4.

[68] Final Advice, Box 68, Paragraph 5.

This represents a significant shift from ESMA's original proposals in the Consultation Paper. Under those, a non-EU delegate would only have been eligible if the local authorisation/registration criteria were 'equivalent' to those under EU legislation. ESMA's retreat from its original position reflects the fierce objections of many respondents to the Consultation Paper, who were of the view that the imposition of equivalence requirements was not provided for in the text of the Directive, would exclude many potential non-EU delegates of significant experience and reputation, and as a result warranted no place in ESMA's Final Advice.

Depositaries

In most cases, the Directive requires that a depositary be located in the EU. A non-EU fund may, however, appoint a non-EU depositary located in the same jurisdiction as that fund – but only where:

- the relevant regulators in the EU (i.e., in the home Member State and any Member State in which the fund is intended to be marketed) have signed cooperation arrangements with the non-EU regulator of the depositary; and
- the depositary is subject to effective prudential regulation and supervision which is of the same effect as EU law.[69]

The Directive, then, is very clear that a non-EU depositary must be regulated in a way that is equivalent to EU regulation. Capital requirements, eligibility criteria and operating conditions should all be "equivalent" to those of EU banks or investment firms.[70] As with all delegates, the non-EU depositary must be subject to penalties for breach that are "sufficiently dissuasive".

Essentially, ESMA expects non-EU depositaries to be as rigorously regulated and supervised as EU depositaries. Given that the Directive's flexibility in allowing for non-EU depositaries is limited, this is likely to result in there being a small pool of eligible non-EU custodians that may perform that role.

Conclusion

When analysing the effectiveness of ESMA's proposals, it is impossible to ignore the magnitude of ESMA's task. The Final Advice covers a plethora of implementing measures. Adding to the complexity of ESMA's role is the fact that ESMA needs to ensure that its technical advice applies to the varied types of alternative funds captured by the Directive.

Given all of that, ESMA's advice is for the most part measured, proportionate and adds much-needed clarity. However, there are instances and areas where the Final Advice falls short.

Take depositary liability as an example. ESMA's interpretation of the Directive is such that its Final Advice would make a depositary liable for the fraud of an unaffiliated, third party custodian unless the liability can be 'transferred' down to the sub-custodian. The depositary may have limited actual control over such a sub-custodian. This liability regime is expected to increase—perhaps significantly—the fees charged by depositaries to funds.

[69] Directive, Article 26(1).

[70] Final Advice, Box 76.

It should be remembered that the Directive is concerned with alternative investment funds which are unlikely to be available, in the main, to retail investors. It is questionable whether all institutional and professional investors will welcome the tighter investor protections that ESMA's Final Advice envisages, particularly if the cost were to adversely affect fund performance.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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