ECMI Commentary
No. 34/March 2013

Implementing the AIFMD: Success or failure?

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EU member states have to transpose the alternative investment fund managers Directive (AIFMD) into national law by July 2013, marking the end to an ambitious and complex legislative process initiated back in 2009. The implementation of the Directive by the European Commission, in the form of a delegated Regulation[1] issued last December, has achieved a great deal in remaining faithful to the Directive while making the regime far more workable than many in the industry had anticipated.

This commentary focuses on four key aspects: the limits to delegation of risk and portfolio management, the depositary duties and liabilities, the measurement of leverage, and the frequent recourse to the proportionality principle in the delegated Regulation. It also considers the remuneration guidelines recently adopted by the European Securities and Markets Authority (ESMA).[2] It finds that both the European Commission and ESMA have followed a practical and flexible approach to implementation, which should help secure the success of the framework, which is still today uncertain. The implementation has however toughened the stance on the methodology to calculate leverage, with limited impact for AIFs (Alternative Investment Funds), but potential repercussions for UCITS.[3]

The Directive in hindsight

The AIFMD is not a hedge fund Directive, as frequently portrayed, but the default framework for the asset management industry in Europe. It also covers managers of private equity, infrastructure and any other fund type that is not a UCITS. By bringing all non-UCITS managers into a single framework, the Directive should avoid constraining innovation. Few but very significant restrictions are imposed by the Directive and these apply chiefly in four respects: i) *delegation*, to limit the circumvention of its provisions; ii) *remuneration*, to ensure it aligns with best practices in risk management; iii) *conflicts of interest* between prime brokers and depositaries; and so-called iv) *asset stripping* for private equity managers. The AIFMD does not prescribe asset allocation or maximum leverage, in contrast with UCITS.

Despite this relatively benign approach, the Directive introduces substantial compliance and disclosure burdens, notably with regard to custody and valuation, which could ultimately hurt returns for investors (de Manuel & Lannoo, 2012). Arguably these burdens are justified to better *protect professional investors* and end beneficiaries and to *equip supervisors* with the information and tools they need to monitor flows and risks – in line with the lessons drawn from the financial crisis (Turner, 2009; de Larosière, 2009). Yet, whether the benefits of transparency and reliability will outweigh the cost is still unclear and will depend on the ability of intermediaries to deliver competitively-priced services and the preference of investors for AIFs versus off-shore vehicles. The outcome also hangs on the practical implementation of the Directive at EU and member state level.

[1] Commission delegated Regulation of 19 December 2012 supplementing Directive 2011/61/EU with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision [publication in the Official Journal of the European Union pending].

[2] Guidelines on sound remuneration policies under the AIFMD, ESMA/2013/201.

[3] See the consultation on UCITS with regard to product rules, liquidity management, depositary, money market funds and long-term investments, issued by the European Commission on 26 July 2012.

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The importance of the AIFMD framework for the European economy should not be underestimated, as it sets the ground for asset managers to offer their services to professional investors freely across member states. By opening the single market for asset managers, without the product constraints of UCITS, the AIFMD has the potential to contribute to the recovery in Europe by furthering the development of its capital markets, increasing the diversity of funding sources and reducing its historical dependence on bank finance.

Key notes on implementation

In December 2012, the European Commission adopted a delegated Regulation implementing the AIFMD, with the exception of the rules regarding market access for non-EU funds and managers, to be implemented at a later stage (de Manuel, 2011).[4] The process had been the object of controversy given the technical reservations expressed by Commission about the advice delivered earlier by the ESMA, which explains the delay in its adoption.[5] The final text demonstrates however the importance attached to securing the success of the framework. The next sections will consider the way in which three key aspects are implemented: i) the limits to the delegation, ii) the depositary framework and iii) the measurement of leverage. It also considers the use of the proportionality principle, allowing for a targeted application of the Directive with regard to the different nature, scale and complexity of AIFs.

1. Workable limits to delegation, pending arrangements with third countries

The AIFMD requires managers to justify their entire delegation structure on *objective reasons*.[6] It also limits the delegation of portfolio and risk management to supervised managers.[7] And it prohibits managers from delegating their functions to the extent that they cannot be considered the managers of the AIF and become 'letter-box' entities.[8] The vagueness of these requirements raised many concerns for the industrial organisation and competitiveness of the EU asset management industry and its ability to access local expertise in emerging markets. The implementing Regulation has, however, largely addressed these concerns; while it may result in the restructuring and in-sourcing of some activities, the regime will not limit delegation unduly – provided the required supervisory arrangements are concluded with third countries – as discussed below:

- As *objective reasons*, the implementing Regulation considers not only accessing expertise in markets, investments or trading capabilities but also cost savings and the optimisation of business functions.[9] The instances are so broad that one would have a hard time finding any reason for delegation that would not be permissible. Assessing whether delegation is aimed at circumventing the Directive becomes a rather subjective test. This probably contradicts the intent of the legislator but the intention in all likelihood was highly abstract, which is difficult to implement in any event.
- The implementing Regulation also clarifies that "entities authorised or registered for the purpose of asset management and effectively supervised" are considered equivalent – whether EU or foreign. Delegation to non-EU managers is possible as long as the supervisor of the home member state has signed a cooperation arrangement with the authorities in the third country. This requirement is of great concern given the limited progress achieved in negotiating these arrangements so far and the proximity of the deadline (July 2013).
- The prohibition against 'letter-box' entities is also muted by the vast array of qualitative factors that competent authorities should consider, including the investment goals, strategies and risk profile of the AIF, as well as the geographical and sectoral spread of its investments.[10] The many criteria under consideration are probably justified but they open the door for competition among fund domiciles for the most business-friendly approach to delegation. Given the risk, the European Commission has asked ESMA to harmonise supervisory practices and will review their application in 2015.[11]

All in all, the application of the limits to delegation will depend on national supervisors, which should facilitate the competitiveness of EU asset managers, while deterring abuses aimed at circumventing the Directive. It is now a matter for these supervisors to conclude the necessary arrangements with third countries before the entry into force of the Directive, under the coordination of ESMA.

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[4] Commission delegated Regulation of 19 December 2012 supplementing Directive 2011/61/EU with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision [publication in the Official Journal of the European Union pending].

[5] Technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/379.

[6] Art. 20 (1) (a) AIFMD.

[7] Art. 20 (1) (c) AIFMD.

[8] Art. 20 (3) AIFMD.

[9] Art. 78 (2) Implementing Regulation.

[10] Art. 76 (1) Implementing Regulation.

[11] Art. 82 (3) Implementing Regulation. Note also that a manager without sufficient resources and expertise to perform both the portfolio and risk management functions should be denied authorisation to begin with, according to Arts 6 and 18, AIFMD.

2. *Softened edges and more clarity for depositaries*

The AIFMD entrusts depositaries with controlling the legal title of assets, keeping assets in custody or otherwise in record, monitoring cash flows and several oversight functions.[12] When implementing the Directive, the crucial question was which assets can be kept in custody instead of kept in record given the different standard of applicable liability.[13] The loss of an asset kept in custody entails strict liability while, in record-keeping, liability arises only in the case of negligence or intentional failure.[14] The rules are tough, but implementation has softened the edges.

On the scope of custody, the Commission largely follows the advice of ESMA: assets to be held in custody are transferable securities, money market instruments and fund units capable of being held in an account in the name of the depositary.[15] These are instruments that can be held in an account in the name of the depositary and over which the depositary has control. Listed derivatives are excluded from the custody duty, pending the introduction of the securities law Directive (SLD) and the Regulation on OTC derivatives, central counterparties and trade repositories (EMIR). Transferable securities embedding a derivative however are subject to the custody obligation.

Less clear-cut is the situation arising from collateral arrangements, securities lending and repos. Under the implementing Regulation, assets will exit custody, only if there is a transfer of ownership away from the AIF. One therefore needs to look at each transaction. For collateral arrangements, the collateral Directive distinguishes between *title-transfer* and *security* arrangements: under the latter, there is no transfer of title so the assets remain in custody.[16] But without harmonised securities and bankruptcy laws, problems will continue to arise in practice.

The implementing Regulation also clarifies the strict liability standard and conditions for exoneration. To avoid liability for the loss of an asset held in custody, the depositary would have to prove three conditions: i) it did not cause the event leading to the loss; ii) it could not have reasonably prevented the event; and iii) it could not have reasonably prevented the loss.[17] The key condition is the last one since it imposes on the depositary a duty of due diligence to monitor any risks and take appropriate action. If the risk is significant, the depositary must inform the manager and could, under certain conditions, discharge its liability.[18]

Beyond custody, the Directive transforms a single depositary into a sort of censor or auditor of the manager. Even core functions, such as asset and risk management, could be affected by the depositary issuing warnings, as just mentioned. The implementing Regulation goes so far as to confer upon the single depositary the power to access books and perform on-site visits to the manager and any service provider appointed by it, including administrators and valuers.[19] Policing powers are an anecdote, but they epitomise the profound changes in business practices and contractual relationships that are about to take place. The implementing Regulation also details the cash monitoring and oversight functions.[20]

The AIFMD consolidates custody as the central element that differentiates asset management from other forms of financial intermediation. This is a positive development for the industry, as it protects the agency nature of its business. It also sets the ground for greater expansion of asset management in Europe as a vehicle to channel savings into investments, in a far simpler and safer fashion than traditional banking and insurance, given the identification and segregation of assets.[21] However, the complexity of the depositary regime in the AIFMD, despite smart implementation, is great (far greater than presented here). Whether the benefits will outweigh the costs is not clear yet and will depend on factors, including notably the ability of the depositaries to deliver efficient and competitively-priced services in compliance with the Directive.

3. *Further flexibility through proportionality*

Further flexibility comes from the introduction of the proportionality principle by the implementing Regulation in several provisions. The principle entails, for the provisions affected, that they should not necessarily be applied in full but in a way that is proportionate to the nature, scale and complexity of the AIF, and the size and organisation of the AIFM. Large managers of complex funds should comply in full, while a small manager running, e.g. an unleveraged fund should be spared any compliance burden that is

[12] Arts. 20 (7) – (10) AIFMD. Custody involves holding a security, either physically or electronically while record-keeping only concerns taking note of the given right or contract. See de Manuel & Lannoo (2012), pp. 81-89.

[13] Art. 20 (8) AIFMD.

[14] Art.20 (12) AIFMD.

[15] Art. 88, Implementing Regulation.

[16] Directive 2002/47/EC.

[17] Art. 101, Implementing Regulation.

[18] Art. 102, Implementing Regulation.

[19] Art. 92 (4) Implementing Regulation.

[20] Arts 87-87 and 92-97, Implementing Regulation.

[21] The argument that asset management is a simpler and safer form of financial intermediation than traditional banking and insurance is also supported by two other elements: i) the limited extent of maturity and liquidity transformation (as far as the maturity and liquidity of the underlying assets are in line with the redemption policies) and ii) the absence of guarantees. Caveats are the extensive use of derivatives and securities lending where they are present (de Manuel & Lannoo, 2012).

not justified to achieve the objectives of the Directive.[22]

Since the AIFMD applies in principle to any non-UCITS manager, without either defining business models or investment strategies or constraining eligible assets, the proportionality principle is of great consequence.[23] The implementing Regulation introduces this principle in 16 provisions referring to organisational requirements, conflicts of interest, securitisation positions, risk management, liquidity management and depositary duties. Table 1 in the Annex provides an overview of these provisions.

It will fall primarily on national supervisors to monitor the application of the proportionality principle in practice, and develop guidance or supervisory practices that improve legal certainty for market participants. In principle, proportionality should apply only when the Commission's implementing Regulation explicitly allows. The proof of the pudding will be in the transposition of the Directive and the development of supervisory practices by member states. The Commission and ESMA will need a watchful eye to protect the level playing-field within the newly created single market.

4. *Neutralisation allowed for remuneration*

The AIFMD also recognises the proportionality principle in the application of its provisions regarding remuneration and mandates ESMA to develop guidelines taking due account of this principle.[24]

The rules on remuneration have several objectives, sometimes conflicting: i) promote the alignment of remuneration policies with the interest of investors; ii) mitigate risk-taking for macro-prudential purposes and iii) avoid the reward of failure. The investor protection goal has been heavily criticised by the industry which considers that professional investors do not need protection, given their expertise and contractual power. But the evidence from the financial crisis points rather towards the importance of micro-prudential risks and their link with financial stability (Turner, 2009; de Larosière, 2009).

In the pursuit of these goals, the AIFMD goes beyond principled-based regulation and contains some hard obligations such as the attribution of at least 50% of variable remuneration in fund units or the deferral of at least 40% of variable remuneration in a period appropriate to the life-cycle of the AIF. The industry has argued that these limits are too severe and, being originally devised for banks, fail to take into account the nature of the agency business of asset managers. Regulators have privileged here the uniformity of the rules applied across intermediaries to limit arbitrage.

Besides compliance costs, there is genuine concern that the rules could have an inflationary effect on compensation. While the rules do not limit the total amount paid, policies such as deferrals may have an impact on the attractiveness of the EU industry as an employer. Management houses may need to offer higher total remuneration to compensate for deferrals, given competition from other jurisdictions where more lenient regimes apply.

Nevertheless, the deferral of variable remuneration, coupled with the assessment of performance in a multi-year framework, are central to managing assets in accordance with the interests and investment horizons of clients and end beneficiaries.[25] The long-term benefits for the business models of EU asset managers should largely outweigh any short-term drawbacks.

Moreover, under the ESMA guidelines, proportionality would apply at two levels: i) among AIFMs, with respect to their size, internal organisation, and nature, scope and complexity of their activities; and ii) within each AIFM, with respect to the different categories of staff and their impact on the risk profile of the AIF.[26] The guidelines allow for *neutralisation* in exceptional circumstances, meaning the disapplication of some of the provisions on remuneration in the Directive.[27]

The industry is split between its desire for legal certainty and flexibility, both of which cannot be achieved at the same time. In the interest of flexibility and given the wide variety of business models captured under the AIFMD, ESMA has not based its guidelines on quantitative thresholds. However, it may need to develop its qualitative guidance further to provide more certainty and foster supervisory convergence.

5. *Toughened calculation of leverage*

The calculation of leverage is important in two respects, firstly, to determine the size of the manager

[22] Also in line with the de minimis thresholds in the Directive (Art. 3, AIFMD).

[23] See the explanatory addendum to the Regulation implementing the AIFMD (p. 4).

[24] Art. 13 and Annex II, AIFMD.

[25] The Directive does not mandate a specific multi-year framework for assessing performance and deferring remuneration. Instead it asks the AIFM to do so in line with the life cycle and redemption policy of the fund.

[26] Guidelines on sound remuneration policies under the AIFMD, ESMA/2013/201. Against this background, the role of the ESMA guidelines is to facilitate a common understanding of the Directive by business and supervisors. The choice of instrument is important since guidelines are soft law, which does not bind managers directly but only through the action of national supervisors. The guidelines are of particular importance to determine how the proportionality principle will apply in practice to remuneration policies.

[27] Paragraphs 25-27, ESMA guidelines. It is interesting to note that the draft guidelines did not explicitly allow for *neutralisation.*

and whether it needs to comply at all with the Directive, and secondly, to establish whether it runs leverage on a *substantial basis* and is subject to additional reporting obligations.[28] Contrary to the trend elsewhere, the implementing Regulation follows here a stricter approach than anticipated.

EU legislation has traditionally recognised *value at risk* (VaR)[29] as a tool to measure not only risk but also leverage, as in the advanced method to calculate global exposure under the UCITS Directive.[30] Despite the advice of ESMA, the European Commission has completely discarded the use of VaR to measure leverage under the AIFMD. In effect, VaR does not measure leverage but only provides an estimation of the maximum potential loss in the value of a portfolio, based on historical data and assumptions such as normally distributed returns. As the European Commission points out, certain investment strategies have low VaR but high leverage.[31]

Instead, managers will have to calculate both gross and net leverage following the commitment approach devised by ESMA for UCITS in 2010.[32] This methodology consists of calculating the sum of the absolute value of all positions and then deducting netting and hedging arrangements. Managers will be constrained by this approach since the proposal of ESMA to allow internal models was also discarded by the Commission, amidst growing distrust on the use of internal models for regulatory purposes.

In sum, the use of VaR for regulatory purposes has been badly discredited as a proxy for leverage as a result of the implementation of the AIFMD, with potential repercussions for UCITS. The debate on how best to distinguish exposure, risk and leverage will continue in 2013, following the UCITS consultation launched last year.[33] If the implementation of the AIFMD is to serve as reference for UCITS, it is likely that the commitment approach will end up being applied on a cumulative basis, rather than as an alternative to VaR, to better enforce the 100% NAV limit set by the Directive for the exposure acquired through derivatives.[34]

Conclusion

Not surprisingly, given the length and complexity of the Directive, its implementation is similarly long and detailed. However, the European Commission has achieved a great deal in remaining faithful to the text while making the regime far more workable than many in the industry had anticipated. The limits to delegation have been made much more flexible and the depositary rules much clearer. The proportionality principle introduced in several provisions should allow for their targeted application to the many different categories of AIFs. Greater flexibility will however demand greater supervisory efforts and, in order to ensure convergence, ESMA will need to play a central role.

The AIFMD creates an internal market for asset management and is an important piece of legislation for the European economy. Its success should foster the development of capital markets and help reduce the historical dependence of the European economy on bank finance. It is too early, however, to proclaim success, which will depend on many factors, including the ability of managers to attract the interest of investors worldwide for AIFs. The safeguards built into the Directive have a price tag but if UCITS is to serve as a reference, also professional investors may be willing to buy. By July 2013, member states should have transposed the Directive into national legislation. As the legislative process draws to a close, the time comes for the industry to move forward. EU and national authorities would be well advised to commit to the success of the framework, to the extent that the European economy needs more market-based finance.

[28] Arts 3 (2) and 24 (4) AIFMD, respectively.

[29] Value at risk (VaR) provides an estimation of the potential decrease in value of a given portfolio based on the past performance of its components. For instance, a VaR (20 days, 99%) of €5 million means that under normal market circumstances, there is a 99% probability that the fund's portfolio will not lose more than €5 million in value in 20 trading days.

[30] The use of value at risk (VaR) to measure global exposure is enabled by Art. 41 (3) of Directive 2010/43/EU, implementing UCITS IV, and developed by ESMA guidelines (CESR/10-788). The VaR limit set in the guidelines effectively substitutes the 100% NAV limit set by Art. 51 (3) of the UCITS IV Directive (2009/65/EC). For a discussion in this respect, see de Manuel & Lannoo (2012), pp. 66-76.

[31] Impact assessment, accompanying the implementing Regulation, SWD (2012) 386 final, p. 29.

[32] ESMA guidelines (CESR/10-788) on risk measurement and the calculation of global exposure and counterparty risk for UCITS.

[33] Consultation on product rules, liquidity management, depositary, money market funds and long-term investments, European Commission, 26 July 2012.

[34] Art. 51 (3) UCITS IV, see note 30.

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Annex

*Table 1. The proportionality principle in the implementation of the AIFMD**

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<tr><th colspan="2">Articles in the implementing Regulation</th><th>Remarks (limited scope, neutralisation)</th><th colspan="2">Corresponding articles AIFMD</th></tr>
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</table>

* Reference is made in the table to the articles where the implementing Regulation allows for certain flexibility so that its rules can be applied in a proportionate way, where justified by the size and the organisation of the AIFM and the nature, scale and complexity of the managed AIF. Neutralisation refers to the permissibility of displaying a given provision in full based on the proportionality principle.

Source: Author's own elaboration.