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COVER NOTE

from: Secretary-General of the European Commission,
signed by Mr Jordi AYET PUIGARNAU, Director

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to: Mr Uwe CORSEPIUS, Secretary-General of the Council of the European
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Subject: COMMISSION STAFF WORKING DOCUMENT
EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT
Accompanying the document
COMMISSION DELEGATED REGULATION (EU) No ../.. of 19.12.2012
supplementing Directive 2011/611/EU of the European Parliament and of the
Council with regards to exemptions, general operating conditions, depositaries,
leverage, transparency and supervision

Delegations will find attached Commission document SWD(2012) 387 final.

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EUROPEAN
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EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

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COMMISSION DELEGATED REGULATION

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with regard to exemptions, general operating conditions, depositaries, leverage,
transparency and supervision**

{C(2012) 8370 final}
{SWD(2012) 386 final}

1. INTRODUCTION

The Framework Directive (AIFMD)

The Directive on Alternative Investment Fund Managers¹ (AIFMD) introduces harmonised requirements for entities engaged in the management and administration of alternative investment funds (AIF) addressed to professional investors in the EU.² The marketing of AIF to retail investors and the sale of units or shares at the initiative of the investor ('passive marketing') are not covered.

The Directive covers a large variety of alternative investment funds (AIF) and their managers (AIFM) ranging from equity funds to funds investing in illiquid assets (real estate, private equity, infrastructure, commodities or goods like wine or art). It covers all possible investment strategies and legal forms.

To obtain authorisation the AIFM has to comply with the requirements of the Directive which range from, among others, capital requirements, risk and liquidity management, the appointment of a single depositary to rules regarding disclosure to investors and reporting to competent authorities.

The investment fund sector

With the AIFMD, all investment funds in the EU fall into one of the following two categories: They are either UCITS (undertakings for collective investment in transferable securities) or AIF. UCITS funds are governed by the UCITS Directive (2009/65/EC) and are authorised for sale to the retail market. They are not the subject of this IA report.

With almost 6trn€ of assets under management in the EU the UCITS fund is almost three times bigger than the AIF sector (2.2trn€). In 2010, the overall assets under management (AuM) by all categories of AIF amounted to 18% of EU GDP.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

The AIFMD provides for extensive delegated acts. While it does not contain deadlines for the delivery of these acts, the Commission aims to deliver the entire package of implementing legislation in time prior to the end of the transposition period (July 2013).

On 2 December 2010, the Commission sent a request for technical advice on the level 2 measures to the Committee of European Securities Regulators (CESR). The European Securities and Markets Authority (ESMA, which replaced CESR as of 1st of January 2011) transmitted its technical advice to the European Commission on 15 November 2011.³

Throughout the process of drafting its advice, ESMA was in close contact with the relevant industry by means of bilateral meetings and open public consultations. Stakeholders showed

¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>

² The AIFMD also covers the marketing of AIF established in third countries to professional investors in the Union as well as the management of AIF established in the Union, even if they are not marketed to investors in the Union.

³ http://www.esma.europa.eu/system/files/2011_379.pdf

great engagement, as evidenced by number of responses ESMA received to its written consultations.

In addition to the written consultations, ESMA organised three open hearings covering the Call for Evidence and the two parts of the draft technical advice, the first in January and the second two in September 2011. Summaries of these hearings as prepared by ESMA are attached to this impact assessment report. Furthermore, ESMA invited around 20 selected stakeholders to participate in a series of targeted workshops on the different parts of the technical advice between March and May 2011.

3. PROBLEM DESCRIPTION

Problems identified in the level 1 impact assessment

Four of the problems identified in the level 1 IA are important in in choosing level 2 measures:

1. Macro-prudential (systemic) risks: Macro-prudential oversight of the AIF sector is currently hindered by the absence of a consistent approach to the collection of macro-prudential data (on leverage, risk concentrations etc) and of effective mechanisms for the sharing of this information between EU prudential authorities.

2. Micro-prudential risks: AIFM in the EU are not currently subject to consistent requirements on risk management procedures and processes – this presents risks for investors, counterparties and the market at large.

3. Investor protection: National regulatory approaches to disclosure and AIF governance vary and do not provide a consistent level of investor protection.

4. Market efficiency: AIFM activity may impact not only on financial stability but also on the efficiency and integrity of the markets in which they operate. .

Without further level 2 measures, the AIFMD risks being implemented differently across the Union. This could result in: (1) lack of legal certainty for AIFM, AIF depositaries, AIF investors and other stakeholders (such as AIF counterparties); (2) no level playing field for AIFM across Member States; (3) a lower level of investor protection for AIF investors; and (4) greater micro- and macro-prudential risks as cross-border supervision would not be effective.

In short, in the absence of level 2 measures, the achievements of the core objectives of the AIFMD would be put in question; the EU would still be left with considerable systemic and micro-prudential risks, a less efficient AIF market and a lower level of investor protection.

Scope of the issues addressed in the Level 2 impact assessment

The ability of the AIFMD to achieve its policy goals will depend on how level 2 deals with eight issues:

Issue	Level 2 empowerment	Content
Issue 1:	Article 3 (6): Exemptions	The method of calculating the AIFM's assets under management is key in defining the AIFMD's scope
Issue 2:	Article 4 (3): Definitions	The method of how <i>leverage</i> is to be calculated is important for an early identification of systemic risk.
Issue 3:	Article 9 (9): Additional own	The requirement of additional own funds or of a professional

	funds	indemnity insurance (PII) that covers professional liability risk has implications for the level of investor protection achieved by the AIFMD.
Issue 4:	Article 21 (17): Depositary	The perimeter of financial instruments that can be registered in a depositary's financial instruments account determines the scope of the latter's obligation to return instruments lost in custody.
Issue 5:	Article 21 (17): Depositary	The scope of liability for losses that occur while an instrument is held in custody determines the level of investor protection.
Issue 6:	Article 21 (17): Depositary	The precise scope of <i>cash monitoring</i> is important for investor protection.
Issue 7:	Article 24 (6): Reporting to competent authorities	Reporting frequencies are decisive in achieving adequate monitoring of systemic macro- and micro-prudential risk and an adequate level of investor protection.
Issue 8:	Article 24 (6): Reporting to competent authorities	The issue of when <i>leverage</i> is to be considered to be <i>employed on a substantial basis</i> is crucial in triggering the reporting obligations in Article 24(4) AIFMD.

4. THE EU'S RIGHT TO ACT AND JUSTIFICATION

The European Commission's and the EU's right to act is established in the impact assessment which accompanied the AIFM Directive 2011/61/EU. The AIFMD aims to provide a clear and consistent framework for the regulation and supervision of AIFM in the EU, it establishes at European level a mechanism for creating a single European market for alternative investment funds in line with the legal base underpinning Community legislation in this area (Article 53(1) TFEU).

5. OBJECTIVES

The two overarching objectives of the AIFMD are to provide a clear and consistent framework for the regulation and supervision of AIFM in the EU and to ensure a high level of investor protection in the Union. This leads to the following specific objectives:

1. A common approach to calculating AuM;
2. Common methods to determine an AIF's leverage, both as a reflection of the AIF's "footprint" and as a trigger for leverage-related reporting ('substantial use of leverage');
3. A common approach on an AIF's level of additional own funds (operational continuity);
4. A common approach on the scope of custody and on the depositaries liability to return financial instruments lost in custody;
5. A common approach to AIF's reporting frequency.

5. OPTIONS

Issue 1: Calculation of total assets under management

The preference, in line with the advice received from ESMA, is to calculate total AuM using the value of all assets managed by the AIFM without deducting liabilities and valuing

financial derivative instruments (FDIs) at the value of an equivalent position in the underlying assets. Valuing FDIs as if the underlying assets were acquired by the fund reflects the AIF's exposure to these assets.

Issue 2: Calculation of leverage

The preferred option is to combine the so-called 'gross' and the 'commitment' methods. The leverage ratios that result from applying the gross method are consistent with the objective to monitor macro-prudential risks. The commitment method is well established and recognised in the asset management sector. Its results can be easily compared with those for UCITS funds. It provides, in particular when combined with the gross method, a good insight into the investment strategies and exposure of AIF relevant for both investors and supervisors. In case of proven necessity for an additional method to better apprehend systemic risk, the precise parameters of such an 'advanced' method should be established by EMSA. This method would then be adopted by modifying the delegated act. Recourse to an advanced method must not obviate the calculation of leverage according to the gross and commitment method – both remain obligatory for all AIFM.

Issue 3: Additional own funds

The preferred option would require that additional own funds to cover professional liability risks amount to 0,01% of AuM, calculated on gross assets valuing derivatives at market price. In the alternative, a professional indemnity insurance (PII) with a coverage of 0,9% of AuM for aggregate of claims per year and 0,7% of AuM per individual claim seems appropriate to protect investors from damages that result from the AIFM's professional failures. This approach deviates from the ESMA advice which had proposed a minimum threshold and a cap on the PII. This proposal was not consistent with the absence of any cap in calculating additional own funds.

Issue 4: Depositary - Scope of custody

According to the preferred option all financial instruments which can be registered in a financial instruments account (essentially, transferable securities, money market instruments units in collective investment undertakings) and which belong to an AIF must be held in custody. The proposed approach deviates from ESMA to the extent that AIF assets may not be excluded from the scope of custody simply because they are subject of a security interest collateral arrangement. Therefore, should an AIF provide its assets as collateral to a collateral taker, the AIFMD requires that these assets remain in custody – except if the AIF transfers ownership of the collateralised assets to the collateral taker (title transfer collateral arrangement).

Custody of the collateralised AIF assets can be ensured in three ways: (1) the collateral taker is appointed custodian over the collateralised AIF's assets; (2) the AIF's depositary appoints a sub-custodian that acts for the collateral taker or (3) the collateralised assets remain with the AIF's depositary and are 'earmarked' in favour of the collateral taker. All of the above custody arrangements reflect industry practice ensure that the depositary is not liable for the return of assets that are beyond its 'control' (the issue that ESMA attempted to address by excluding all collateral from the scope of custody). In addition, the proposed approach, in line with the AIFMD, level 1, does not require that a CCP to become a sub-custodian.

Issue 5: Depositary - Definition of an "external event"

The preferred option, in line with the ESMA advice, is to consider as external all events not related to the operational sphere of a depositary or its appointed network of sub-custodians (this 'operational sphere' comprises e.g. fraud in the custody operations, operational failures, non-compliance with the AIFMD's operational requirements...). In the event of insolvency of a sub-custodian, operational failures by the latter (e.g. failure to implement the segregation requirement) would not be an "external event". External events would thus be natural disasters or acts of state, government measures (e.g. market closures).

Issue 6: Depositary - Scope of cash monitoring

The preferred option would oblige the depositary to perform ex-post periodic reconciliations of AIF's cash flows. This would enable the depositary to identify cash flows which appear inconsistent with the AIF's stated investment strategy and could notify the AIFM and, if the discrepancies are not resolved, the competent authority. The preferred option avoids the significant costs that could result from delays in AIF's transactions if an ex-ante cash monitoring regime was introduced.

On the other hand, a cash monitoring regime where the depositary only verifies that the AIFM or a third party has procedures in place to reconcile the AIF's cash flows and monitors the outcomes of the reconciliations is considered less effective and robust than the preferred option. The effectiveness of such a verification regime would entirely depend on the effectiveness and accuracy of the cash monitoring and reconciliations by the AIFM itself with the inherent conflicts of interest. Since the AIFM or a third party are not legally required to perform the reconciliations, the verification regime also entails legal uncertainty as to whether the reconciliations would be performed at all and whether the depositary has duly discharged its cash monitoring obligations.

Providing legal certainty and avoiding operational weaknesses and risks of fraud were the main reasons for deviating from the regime based on verification of procedures as proposed by ESMA.

Issue 7: Reporting to competent authorities

Based on the combination of the ESMA advice and regulatory reporting standards in a major non-EU AIFM jurisdiction, the preferred option is quarterly reporting for AIFM with AuM greater than € 1 bn; semi-annual for AIFM between the AIFM's thresholds and € 1 bn; and annual for AIFM with AuM below the AIFMD threshold.

Furthermore, managers of 'unleveraged' AIFs which invest in non-listed companies and issuers in order to acquire control will only have to report on an annual basis. This exemption takes into account the particular investment policy that characterises private equity and venture capital and reflects the best compromise to avoid administrative burdens for smaller AIFMs. IT also reduces the amount of information to be 'digested' by the competent authorities. .

Issue 8: Leverage employed on a substantial basis

Under this option, an AIF would be considered to be employing leverage on a substantial basis when its exposure, as calculated using the 'commitment method', exceeds three times the net asset value (NAV) of the AIF. The preferred option provides the best trade-off between adequate reporting on leverage and the administrative burden on the AIFM and the competent authorities. Setting the threshold of reporting at 3 times the NAV would achieve leverage-

related reporting by AIFMs that employ higher levels of leverage while exempting AIFMs whose leverage is similar or close to those employed by UCITS. The option would also provide level playing field and legal certainty to AIFMs as to their reporting obligations. The interest of providing legal certainty was the main reason for deviating from the self-assessment by the AIFM as proposed by ESMA.

Overall impact of AIFMD level 2 measures

By ensuring a harmonised implementation and application of the AIFMD the level 2 measures will make sure that the main objectives of the level 1 Directive, micro- and macro-prudential risk oversight, investor protection, and market efficiency, can be achieved without imposing excessive administrative burden and costs on AIFMD and other relevant stakeholders (e.g., depositaries).

7. CHOICE OF LEGAL INSTRUMENT FOR ALL LEVEL 2 MEASURES

A regulation, creating a single AIFMD rulebook, guarantees full harmonisation and provides AIFM, professional investors and other stakeholders with the requisite level of legal certainty as to their obligations. A Regulation also ensures full market integration and a level playing field for all AIFM. The implementation by means of a Directive, on the other hand, would either leave some uncertainty for players and would risk that objectives like macro-prudential oversight or improved investor protection could not be fully achieved.

8. MONITORING AND EVALUATION

Monitoring of the practical effect of the AIFMD will be conducted in close cooperation with ESMA as well as with the ESRB (on a more aggregate level).

In addition to this monitoring, the final provisions of the Directive (Articles 67, 68 and 69) establish a thorough evaluation programme by requiring analyses of the impacts of (parts of) the Directive by July 2015 (passport) and July 2017 (scope of the AIFMD).